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DEPARTMENT OF DEFENSE SUBCONTRACTOR KICKBACKS

HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT OF GOVERNMENT MANAGEMENT

OF THE

COMMITTEE ON GOVERNMENTAL AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 27, 1986

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DEPARTMENT OF DEFENSE SUBCONTRACTOR KICKBACKS

THURSDAY, FEBRUARY 27, 1986

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT
OF GOVERNMENT MANAGEMENT,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, DC.

The subcommittee met at 9:40 a.m., in room SD-342 of the Dirksen Senate Office Building, Hon. William S. Cohen (chairman of the subcommittee) presiding.

Present: Senators Cohen, Levin, Rudman, and Chiles.

Staff present: Susan M. Collins, staff director; Linda J. Gustitus, minority staff director and chief counsel to the minority; Jeffrey A Minsky, staff investigator; Elise J. Bean, minority counsel; Allison C. Giles, minority professional staff member; Frankie de Vergie, chief clerk; J. Kenneth Schreier, congressional fellow, minority; Sonia P. Fois, professional staff member; and Ron Miller, intern.

Senator RUDMAN [presiding]. The subcommittee will be in order. The chairman, Senator Cohen, will be here shortly.

To start the hearing, I will ask the ranking Democrat, Senator Levin, to give his opening statement.

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Thank you, Senator Rudman.

In fiscal year 1984, $47 billion was spent by the Defense Department on subcontracts. That is almost a third of the entire procurement budget for that year. That percentage has held pretty steady over the previous years and over subsequent ones. What we will hear today is that a sizable amount of that money is being spent, not for necessary equipment, parts or services, but for payoffs, kickbacks, and rigged bids. The problem is widespread and well-entrenched.

We won't be hearing today from "Mr. Smith," who was going to be our anonymous witness. The reasons for that will be explained by our staff investigator, who will testify later. I talked with him last night. His decision not to come to Washington is based on a fear of retaliation against the business for which he works and against himself personally, if there were any disclosure of his identity, and is based on his fear that the guarantee of anonymity could not be ironclad.

This terrible fear says much about the state of corruption, perhaps as much as his testimony could tell. Imagine. An honest sub-

contractor is afraid of telling the story about kickbacks and bid rigging on the part of employees in defense prime contractors.

I am convinced from our investigation, including today's testimony, that kickbacks and corruption are a rampant disease in the area of defense subcontracting. There is pervasive corruption out there. We are going to go after it. If our laws are inadequate, we are going to hear about that today, and we are going to change them. Our pockets are being picked, and we are going after the pickpockets.

The taxpayers are entitled to that. So are the honest contractors and the honest subcontractors, who represent the majority of businesses working in the defense industry. And I want to emphasize that, because while I believe and others believe that there is rampant disease out there and corruption, the majority of contractors and subcontractors in the defense industry are honest and the majority of their employees do not engage in this practice. But we will hear estimates that from 10 to 50 percent of the buyers for DOD prime contractors in a given area, may be involved in kickback schemes.

We have on our hands here a national scandal, where business as usual, among a significant number of defense subcontractors and prime contractor buyers, is kickbacks for favorable treatment. What appears to count in the award of many of these important subcontracts is not the price or the performance or the product but the payoffs.

Because our laws are inadequate to deal with this basic corruption, I, along with Senator Cohen, in the next few weeks, will be introducing legislation to strengthen those laws under which kickbacks can be prosecuted.

I am going to ask here, Mr. Acting Chairman, that most of my statement be inserted in the record.

I just briefly want to outline what we think we are going to have to do in the Levin-Cohen bill. It is going to have to accomplish a number of changes in our laws, if we are going to put some teeth into the antikickback legislation that we now have on the books, which has proved inadequate.

First, we are going to have to force the prime contractors to assume greater responsibility for monitoring their buyers. There are a number of ways that we are going to do that. We will hear more about that today.

Second, prosecutors tell us the antikickback statute is just too hard to use. We are going to have to increase the civil and criminal penalties in that statute. They are now too light. They are not comparable to our other fraud statutes. We are going to make the prime contractors, or at least try to make them, civilly liable for their employees' acts, unless the prime contractors have informed the Government about the employees' activities that they learn about and have made a good faith effort to have in place reasonable controls to detect and to prevent the misconduct.

We are going to include in defense contracts a clause which will obligate prime contractors to inform the Defense Department of suspected subcontractor kickbacks. We are going to instruct prime contractors to require an annual sworn declaration from key employees in the procurement process, listing the items or the cash

that he or she accepted from subcontractors during the previous year.

There are many other aspects of the bill which we will be introducing, but basically, we are going to put some teeth into the anti-kickback statute, and we are going to require the prime contractors to do some things. Again, let me emphasize that most primes and subs are honest, but we are going to require them to do some things which we believe will deter the acceptance of kickbacks and the solicitation of kickbacks and the payment of kickbacks by their employees.

The American work ethic rests on the principle that American business makes its decisions on the basis of merit, not on the basis of graft. That principle needs reinforcement through strong criminal and civil laws and contractor management, if we are going to maintain a sound and competitive defense industry doing business in the United States.

Thank you.

[Prepared statement of Senator Levin follows:]

PREPARED STATEMENT OF SENATOR LEVIN

In fiscal year 1984, $47 billion was spent by the Department of Defense on subcontracts—that's almost one-third of the $146 billion defense procurement budget for that year. And that percentage has held pretty steady over the previous years. What we will hear today is that a sizable amount of that money is being spent not for necessary equipment, parts or services, but for payoffs—kickbacks—rigged bids. The problem is wide-spread and well entrenched.

We will hear estimates that 10 to 50 percent of the buyers for DOD prime contractors in a given area may be involved in kickback schemes. 10 to 50 percent! We have on our hands, here, a national scandal—where "business as usual" among a significant number of defense subcontractors and prime contractor buyers is kickbacks for favorable treatment. What appears to count in the award of many of these important subcontracts is not the price or the performance or the product, but the payoffs. In the next few weeks, Senator Cohen and I will be introducing legislation to strengthen the laws under which these kickbacks can be prosecuted.

Let me point out, here, that we will be hearing several prime contractors mentioned by name today. In the cases we have referred to, where indictments and convictions have been returned, only individual employees have been found to be the wrongdoers. None of the indictments that we have studied have involved the prime contractor corporations themselves. That's because the pattern that seems to be emerging is one where the buyers for these companies are operating on their own, freelancing for their own gain, and not for the gain of the larger corporation. In fact the prime contractors themselves are usually one of the victims of these schemes. Of course the principal victim is the American taxpayer whose pockets are being picked for large sums by corrupt buyers for defense prime contractors.

But if these prime contractors are, in part, victims, we will also hear today that many of the prime contractors have been less than vigilant in preventing, detecting, and reporting these schemes, and in this failing have contributed to the problem through inattention and inaction.

The case studies are shocking, and almost every part of the country is represented. In one instance, two buyers from Brown and Root, Inc., a Texas prime contractor, made such unrelenting demands for payoffs that the President of a West Coast subcontractor took out a second mortgage on his home to get the cash. In another, a Northrop Corporation employee purchasing parts for the Stealth bomber program boasted, in a tape recorded conversation we will hear today, that he was lucky to be in on the "ground floor" of that program and with his kickback plan in place he could get "fat" and "happy" in eleven years and retire at 55 to his "little cabin and fishing boat on a river".

In a third case, a buyer for Avondale Shipyard, went so far as to ask the owner of a subcontracting company paying kickbacks to execute a promissory note for the amounts due so that if he died, the buyer could collect from his estate!

The kickbacks paid by subcontractors come in all shapes and sizes. In the cases we studied, most of the subcontractors paid the kickbacks demanded in cold, hard

cash. But kickbacks come in many other forms, including airplane tickets, paid vacations, and new cars. Some cash kickbacks are paid weekly, some monthly, and others on demand. Many are paid regularly for years. One prosecution in Massachusetts turned up a subcontractor who had been paying for 13 years.

Kickback schemes involving bid-rigging raise additional problems. In California, the bid-rigging scams have reached a high degree of sophistication. We have heard reports of a "ten percent club," in which buyers from the prime contractors simply hold "court" with selected subcontractors and divy up the available work for an established 10% "fee." We've learned about a coding scam, in which a prime's employee issued coded bid solicitations to selected subcontractors. One code meant the recipient was to submit an inflated courtesy bid; another meant the subcontractor was to submit an actual bid, inflated just enough to cover the employee's kickback.

The results of this corruption are obvious. Subcontracts allocated on the basis of payoffs rather than on the basis of merit undermine our most basic notions of competitive bidding. Honest subcontractors are, by definition, pushed out of the market; product prices are necessarily inflated, by at least the cost of the kickbacks being paid; these higher costs are inevitably passed on by the prime contractors to the United States; and subcontractors who obtain business by virtue of the bribes they pay are less likely to be interested in producing quality products.

While the available data does not allow us, at this time, to accurately estimate the total budgetary impact of subcontractor kickbacks in the defense industry, the existing cases do enable us to recognize patterns and necessary areas of inquiry. First, the key culprit in the cases is the prime contractor's employee, the one demanding or accepting the kickbacks. The cases suggest that the employee most likely to be taking kickbacks is the prime contractor's so-called first-line buyer, the person dealing face-to-face with the subcontractors. The buyer's immediate supervisor appears to be the next most likely. In some cases, the corruption reaches higher, for example to a procurement manager or a vice president.

Second, the kickbacks we studied were often associated with "small procurements," that is, subcontracts worth less than $100,000. The most rampant corruption seems to apply to the smallest subcontracts, worth less than $10,000, apparently because these procurements attract little notice from upper management officials and often require no more than the buyer's signature for approval.

Third, subcontracts for such items as standard spare parts or supplies are particularly susceptible to abuse, because they involve items of essentially identical quality, whose only distinguishing characteristic is their price. Competitive suppliers have few selling points other than a low price or, perhaps, a payoff to the buyer who chooses among them. Another area of abuse are "hard-to-price" subcontracts such as those for unique parts in defense systems, artwork, graphics, or construction work. Such items are difficult to price within 5 or 10% of their actual cost, especially if there is no price history. Kickbacks are easy to hide in these subcontract bids.

To stop these kickback and bid-rigging schemes, we are going to have to start examining in detail the relationship between our prime contractors and their subcontractors. The theory has been that if the United States monitors the activities of its prime contractors and obtains competition at that level, the prime contractors will, in turn, get the best product and price from their subcontractors. This theory isn't working out in practice. We've got to start focusing on the subcontractor level in the procurement process. After all, as we said earlier, over $47 billion is at stake, or one third of our defense procurement budget.

We must require prime contractors to assume greater responsibility for monitoring their buyers. Many people have told us that it is obvious when buyers are on the take. Their lifestyle far exceeds that of an individual on the average buyer's salary. They go to expensive restaurants for lunch, drive expensive cars, live in expensive homes, take luxury vacations.

But, even when prime contractors discover corruption within their ranks, they may be reluctant to involve the United States due to worries about bad publicity, worsening relations with the Department of Defense, costly administrative proceedings and investigations, and potential liability for their employees' misconduct. The prime contractors' response, therefore, has been to fire suspect employees or allow them to resign. Unfortunately, while this course of action eases the problem for the prime contractor, it does not solve the problem for the United States. Such employees may just move to a new company and resume business as usual.

There are also few incentives in the law to encourage prime contractors to disclose employee kickback schemes. For example, prime contractors are not civilly liable to the United States for the increased procurement costs which result from the kickbacks their employees take.

There are steps we can take to combat this fraud. First, we must force the prime contractors to be more active in addressing the kickback problem. They must improve their procurement controls, especially with respect to small and hard-to-price subcontracts. They can institute a strict, no-lunch-with-subcontractors policy to discourage informal contacts with subcontractors and can rotate buyers among departments to prevent long-term relationships with particular suppliers. They can better monitor the prices bid on standard items to prevent unusual price fluctuations and to build reasonable price histories. They can educate their employees about the consequences of accepting bribes.

Second, we are going to have to tighten up on the governing statute—the Anti-Kickback Act—to make it a better tool for criminal prosecutions and civil recovery. Prosecutors tell us the statute is just too hard to use. Senators Cohen and I will be introducing a bill which will make improvements which are necessary for this statute to be effective.

The Levin-Cohen bill will do several things. First, it increases the civil and criminal penalties for paying or accepting subcontractor kickbacks and prohibits attempted as well as successful misconduct. Next, the bill makes prime contractors civilly liable for their employees' acts, unless the prime contractors have informed the government about the employees' activities and have made a good faith effort to have in place reasonable controls to detect and prevent the misconduct. The bill makes clear that the statute is applicable to kickbacks paid by independent sales representatives and suppliers.

The Levin-Cohen bill also strengthens the government's procurement process. First, it instructs contracting agencies to include in all contracts a clause that obligates prime contractors to inform them of suspected subcontractor kickbacks. Second, the bill instructs prime contractors to require an annual, sworn declaration from each employee in the procurement process listing the items or cash he or she accepted from subcontractors during the previous year.

The American work ethic rests on the principle that American business makes its decisions on the basis of merit and not on the basis of graft. That principle needs reinforcement through strong criminal and civil laws and contractor management if we are to maintain a sound and competitive defense industry doing business with the United States.

OPENING STATEMENT OF SENATOR RUDMAN

Senator RUDMAN. Thank you, Senator Levin.

I want to just make a general observation that anybody who has been a public prosecutor, either Federal or State, or anyone who has been an investigator, Federal or State, looking on an activity that amounts to $300 billion a year, would have to come to the absolute conclusion, sad to say, that human nature being what it is, with a $300 billion activity, there is a lot of lying, cheating, and stealing going on. That has been suspected for a long time. And I want to commend Senator Levin and Senator Cohen for initiating these hearings and for working with various officials in the Justice Department to make the prosecution, and of course, investigation leading to the prosecution, of these people easier than it is today.

I am going to welcome our first witness via a telephone hookup. Because he is U.S. attorney for the Central District of California, he is in the midst of trying an important case. He is in California, and presently out there, it is just a little bit before, I guess, 7 a.m. I guess it is not true that everyone in California sleeps late. Certainly, Mr. Bonner doesn't.

If Mr. Bonner is now hooked up, the staff can advise me that has been done. We will just delay for a moment to allow Mr. Bonner to testify. He intended to be here, but unfortunately, because of his case he could not. Rather than have his statement read, he asked to read it himself. So we will just stand by here for a moment until we get Mr. Bonner on the telephone.

[A pause.]

Senator COHEN [presiding]. Before you begin, Mr. Bonner, I'd like to ask unanimous consent that my opening statement be included in the record.

OPENING STATEMENT OF SENATOR COHEN

This morning, the Subcommittee on Oversight of Government Management is holding a hearing to examine the extent of subcontractor kickbacks in the defense industry and the efforts undertaken to combat this fraudulent activity.

Senator Levin, the ranking minority member on the subcommitte, suggested that we hold this hearing and is to be commended for taking the initiative to focus on what appears to be a very serious—and pervasive—problem.

Subcontractor kickbacks are described by some in the defense industry as a "cost of doing business." The typical kickback scheme involves a purchasing agent for a prime contractor who either accepts or solicits payment from a subcontractor in return for some form of favorable treatment.

In some cases, the subcontractor offers the bribe; while in other cases, the purchasing agent demands payment—often 5 or 10 percent of the cost of the subcontract. In both cases, the consequence is the same: the price of the contract is inflated to cover the cost of the kickback, with the Government, and ultimately the taxpayer, getting stuck with the tab.

Take, for example, the exorbitant tab attached to this $20 welding tip, which fits on the end of a welding gun designed for shipbuilding.[1] This welding tip was sold to Avondale Shipyards in Louisiana for $47 each, the result of an intricate scheme of kickbacks.

The 100 percent plus markup covered more than just the profit margin, however; it also lined the pockets of certain shipyard employees and suppliers who, together, succeeded in defrauding the Government. The kickback scam, according to federal prosecutors, touched all levels of the shipyard from senior managers to maintenance workers.

In early 1983, internal auditors discovered that the shipyard was buying many more welding tips and related material than it could ever use. In fact, Avondale actually paid for more than a half a million dollars' worth of material that was never even provided, with the bills charged to the Navy and the proceeds split between certain shipyard employees and suppliers.

In some instances, the supervisor of accounts payable submitted certain suppliers' bills for double payment, approving both the original and carbon copy, and then sharing in the profit. In other instances, the supervisor would tear up credit memos issued by certain suppliers for welding materials that had been paid for but returned, again, splitting the proceeds.

For those welding tips actually paid for and received by the shipyard, the purchasing agent would conspire with certain suppliers to inflate the price of their bids by a percentage of the amount of the buy, ranging from five to ten per cent depending on the vendor, to cover the cost of a kickback.

A welding warehouse supervisor was also in on the scam as he would direct business to specific suppliers in exchange for a percentage kickback. The warehouse supervisor labeled the welding tips with false identification numbers so that the purchasing agent, who was also involved in the deal, would know to purchase the tips from designated suppliers.

In yet another angle, the warehouse supervisor stole some welding tips and sold them through a bogus company to certain suppliers at half price. These suppliers then re-sold the tips back to the shipyard at 100 percent markup, with the proceeds divided among all those involved.

To date, 26 shipyard employees and suppliers have been convicted in this case for offenses ranging from conspiracy and mail fraud to extortion and embezzlement. I understand, however, that Avondale has instituted significant internal controls to preclude this problem from happening again. Avondale has provided the subcommittee with information about these safeguards, which I will enter into the hearing record.

Ironically, none of the defendants in the *Avondale* case was charged with violating the Anti-Kickback Act. Testimony to be presented today will demonstrate that federal prosecutors consider the Anti-Kickback Act to be woefully inadequate and often resort to other laws, such as the mail fraud statute, to prosecute individuals involved in kickback schemes. Senator Levin and I are drafting legislation that would strengthen the Anti-Kickback Act to remedy this problem.

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[1] Welding tip referred to retained in subcommittee files.

The Avondale example is but one of a number of cases that will be discussed during the course of today's hearing as we attempt to determine the nature and the extent of subcontractor kickbacks in defense procurements.

The subcommittee's objective is not to shed bad publicity on any one company. In fact, our investigation suggests that subcontractor kickbacks are a widespread problem affecting many corporations. Prime contractors often are the victims of corrupt employees and act swiftly to notify Federal authorities once the kickbacks are uncovered. In other cases, however, prime contractors appear to be reluctant to confront this kickback problem.

Through the testimony at this hearing, the subcommittee hopes to determine first, the extent of subcontractor kickback activity in the defense industry; second, the similarities among the various kickback schemes; third, the investigation and prosecution efforts undertaken by the U.S. attorneys offices, the FBI, and other law enforcement agencies to combat this illicit activity; and fourth, the need for stronger laws to deter and punish those who engage in kickbacks.

We will hear testimony this morning from two U.S. attorneys who have been active in prosecuting kickback cases, one involving the *Avondale* case in Louisiana, which I have discussed, and the other focusing on the aerospace industry in California.

Also testifying on the law enforcement panel with the U.S. attorneys will be two representatives from the Federal Bureau of Investigation, who will provide an overview of the kickback scams investigated by the FBI, and a representative from the Criminal Division of the Justice Department, who will recommend changes to the Anti-Kickback Act for improving prosecution efforts.

Finally, a representative from the aerospace industry will testify on his corporation's experience with subcontractor kickbacks and the steps taken to prevent any future problems. Like Avondale Shipyards, Hughes Corporation has instituted an extensive program to educate its employees in the wake of the kickback scandal involving several of its buyers.

I look forward to hearing from our witnesses this morning.

TESTIMONY OF ROBERT C. BONNER, U.S. ATTORNEY, CENTRAL DISTRICT OF CALIFORNIA (LOS ANGELES)—VIA TELEPHONE HOOKUP

Mr. BONNER. Good morning, Senator.

Senator COHEN. Good morning. Mr. Bonner, Why don't you proceed?

We have a number of people sitting at our witness table—Mr. Sheehan, Mr. Jamar, Mr. Volz, and Ms. Toensing.

We would like to have you read your prepared statement,[1] and then at the conclusion of that, several of us will ask you questions.

Mr. BONNER. That would be fine, Senator. If I could, I would prefer to, rather than read my statement, to summarize a few points that I attempted to make in it.

First of all, let me say I am very pleased to have the opportunity to participate in these hearings. I only regret that I am unable, because of the commitment I have in Los Angeles, to appear personally before your committee.

I think your subcommittee knows that I am the U.S. attorney for the Central District of California, which encompasses most of southern California, including the southern California counties of Los Angeles and Orange, among them. It is the most populous Federal district in the country. I thought I would mention that because I want to make sure that the committee is aware that many of the major defense contractors are headquartered or have major facilities in this district.

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[1] Mr. Bonner's prepared statement is on p. 49.

Senator COHEN. If you could keep your voice up. It seems to be dropping a bit.

Mr. BONNER. I think we just have a pretty poor connection, but if you aren't able to hear me, please let me know and we can perhaps ask to switch to another line. Can you hear me all right now?

Senator COHEN. We can hear you fine right now.

Mr. BONNER. Let me—if I could, Mr. Chairman, I would like to take a few moments to summarize the problem of subcontractor kickbacks in the southern California defense industry, at least from my perspective here as the U.S. attorney.

During the last year and a half or so, my office has indicted and convicted approximately 15 defendants for giving or receiving kickbacks in connection with defense subcontracts. Those cases have included prosecutions of the individuals of the Hughes Aircraft Co. and at least one such employee from Raytheon, Hughes Helicopter, and Teledyne. Several of these defendants hold managerial positions, in which they supervise other buyers at the prime contractors. And the defense procurement programs involved in those prosecutions included, among others, the Air Force's Stealth bomber program, the B–6 aircraft and others. The kickbacks that have been prosecuted in my district by my office covered kickbacks taking place roughly during the period from 1981 through 1985.

Based on the evidence which, by the way, Mr. Chairman, included hundreds of hours of undercover tape recorded conversations with buyers at three major prime contractors, as well as other information available to me, it is clear to me that the cases that we filed to date are merely the tip of the iceberg.

In my view, based upon what I have seen, the corrupt practices of paying kickbacks on defense contracts, at least in the southern California area, is a pervasive, longstanding practice, which has corrupted the subcontracting process, certainly, at many, probably most, defense contractors in this area.

It is very, very difficult to give any kind of precise estimate as to the percentage of defense subcontracts which involve kickbacks. That kind of thing is, of course, necessarily, at best, subject to an educated guess. But it appears from all the evidence, at least that available to me, that up to 50 percent of the buyers or frontline procurement personnel with prime contractors in this area, take kickbacks in return for issuing or awarding subcontracts.

Whatever the precise percentage, it is clear that kickback schemes are widespread, and they are one of the most widespread defense fraud problems that we are facing in southern California. They are serious, Mr. Chairman, because kickbacks destroy competition in the marketplace for defense contracts and inflate prices the Government must pay for defense procurement. They also, of course, have the potential for jeopardizing the quality of the defense industry's goods and services, which we depend upon for our military readiness.

Where you have kickback arrangements, they reward those who are willing to pay bribes over those honest suppliers who strive to succeed by offering the highest quality good or product for the lowest possible price. The practice here of kickbacks is so pervasive and entrenched, and it is of such dominating proportions that it is sad to say that many suppliers believe they cannot survive eco-

nomically unless they pay kickbacks to buyers or prime contractors.

I hasten to add that this does not condone and should never be a defense of any sort to the payment of kickbacks by suppliers, but we have seen that attitude. On the buyer's side of the equation, many buyers have indicated that they believe the practice is so widespread and longstanding that they rationalize it by saying—"Everyone else is doing it, why shouldn't I?" In short, like all processes of corruption, once they take root, they magnify and spread, and I think that is what we have seen out here.

Let me say, with respect to the kickback cases that we have prosecuted in this district, that we have seen a rather standard going rate for subcontractor kickbacks, which is generally between 5 and 10 percent of the value of the subcontracts, paid as kickbacks.

Typically, these kickbacks are made by suppliers to the buyers. The buyers are receiving kickbacks in cash, although in some cases we have seen that the buyers, and other persons at prime contractors in a position to influence the award of subcontracts, have set up shell corporations or so-called consulting companies for the purposes of handling their kickbacks, funneled through these shell companies they control.

For example, a vice president of Teledyne took his kickback payments through a shell company for that very purpose. He aptly named it "Profit Makers Enterprises." [Laughter.]

I would like to point out that in addition to kickback schemes between suppliers and buyers for approximately 5 percent of the subcontract, we have also seen buyers negotiate "bump" agreements.

In this situation the buyer tells the supplier the amount by which the supplier can raise—that is, "bump"—his bid and still be the low bidder. In turn, the supplier agrees to split the "bumped" amount of the subcontract with the buyer.

I supplied the subcommittee with an undercover tape recording between a supplier who was cooperating with the FBI and the former manager for procurement at Northrop. The Northrop manager, who has been prosecuted and convicted here by the way, can be heard telling the supplier that he, the supplier, will have to pay the 5 percent of the subcontract as a kickback plus 25 percent of any bump.

One of the other outgrowths of these kickback schemes, Mr. Chairman, as I see it and as we have seen—the almost inevitable handmaiden of kickback schemes—is the practice of so-called courtesy bidding, which is a form of bid rigging.

While bid rigging can, of course, occur independent of a buyer and the prime contractor, the corrupt buyers out here are catalysts for this type of collusion.

Essentially what we are seeing is that the buyer for the prime contractor is on the take, taking kickbacks. He selects the supplier who is to receive the subcontract and orchestrates other suppliers to submit so-called courtesy bids to allow the subcontract to be awarded to the preselected supplier at an inflated price. The suppliers of course can be rotated.

Like all bid rigging, this practice totally destroys the competitive process and competitive pricing.

We have found that courtesy bidding schemes are a common feature of kickback schemes. Several cases have been prosecuted here in southern California.

Finally, let me just say that there is no question in my mind that kickbacks, and the related corrupt, anticompetitive activities that go with them, are a major problem in the southern California defense industry.

I think experience shows that this kind of corruption, like all corruption, the longer it goes unchecked the more difficult it is to stop it because it becomes a way of life.

So in my judgment, it is going to take more than vigorous investigative and prosecutive efforts on the part of the Justice Department. We are also going to need very substantial prison terms for those convicted.

And this is also the situation, Mr. Chairman, in which I believe there are amendments that can be made to the antikickback statute, which would be quite helpful to prosecutors in the field.

Senator, that is essentially a summary of what I wanted to say to the committee.

Are there any questions?

Senator COHEN. Mr. Bonner, thank you very much. I know you have an extremely busy schedule and you are involved in a major spy case this morning. We appreciate your taking time out to deliver this statement by phone.

I would commend your statement to anyone who is interested in perhaps the best synopsis of the problem that we have seen to date.

I think perhaps the most shocking statement you made this morning was that "kickbacks are a pervasive, longstanding practice which has corrupted the subcontracting process at most, if not all, defense contractors and infected most, if not all, defense procurement programs within the Central District of California." You then go on to estimate that as much as 50 percent of those purchasing agents and frontline procurement personnel are involved with kickbacks. That is a rather shocking statistic and revelation.

This morning, we have Senator Levin from Michigan here, who is primarily responsible for asking us to set up these hearings, as well as Senator Warren Rudman of New Hampshire, who has had extensive experience in prosecuting fraud and kickback cases.

The only question that I have is what changes would you recommend to the existing statutes and current industry practice to remedy this kickback problem? What recommendation would you have about how the industry can protect itself or educate its employees against this kind of activity?

Mr. BONNER. Senator, with respect to the statute itself, I would like to defer to the Department of Justice. I believe Victoria Toensing is there.

But with respect to cooperation with industry, or actually the prime contractors, I think there is certainly a role that they have to play if we are to bring this problem under control, and there are a couple of observations I would make.

First of all, I think some prime contractors have attempted to monitor this problem, and it is difficult to do. But some of them tend to be leery about policing their own houses, and so on. The institution of internal procedures by prime contractors is likely to

make it more difficult, in any event, for these kickback schemes to emerge.

The second thing is that they really have to be more cooperative with the FBI and my office. What I mean by that is that if they suspect somebody is on the take it is very important that that be reported to the FBI so some sort of appropriate criminal investigation can take place.

And I think, there again, some of the companies where they suspect something, some of them have simply allowed an employee to resign, and it is not uncommon that he turns up as a buyer over at some other defense contractor.

Senator LEVIN. Mr. Bonner, this is Senator Levin from Michigan.

Again, let me thank you for your very forthcoming and strong statement. My question—and we are going to limit our questions to you because the connection is difficult and because it is 7 o'clock there and you have got a major trial you are involved in—but my question also relates to the prime contractors and what we can get them to do to help us.

Most of them are victims of this, and when they find out that one or more of their employees are involved in soliciting kickbacks from subcontractors, we understand that the instinct on the part of the prime contractors is to try to get those employees out of their employ. But frequently those same employees end up in the employment of another contractor shortly thereafter. It is another form of revolving door, as some have called it.

Now, one of the provisions of the bill that we are going to introduce would be a requirement that the Defense Department put in its contracts a requirement that when a prime contractor suspects that an employee has been soliciting and accepting kickbacks, that that prime contractor notify the Defense Department.

I take it from your testimony here this morning that you would support that provision, that amendment in our bill?

Mr. BONNER. Senator, I would support it wholeheartedly. Of course, when I say the FBI, the Defense Department could also make appropriate arrangements if it were reported to me, so that the inspector general's office of the Defense Department and the FBI can look at it to see whether a criminal investigation is appropriate before the possibility of a criminal investigation is blown, so to speak.

So that is very important. It is important to note also, and my own belief is, that in many instances what really happens here is that when a defense contractor, a prime contractor, discovers some evidence, perhaps not enough at that point to prosecute, but discovers some evidence to indicate that it has a corrupt employee, an employee on the take, that they really just don't want to have the embarrassment of having one of their employees, one of their buyers prosecuted.

I don't want to say it is a cover-up, but their instinct may be different than the one that I would like to see. What I would like to see is, at a point where it can still be investigated, that information turned over to the appropriate Federal investigative agencies, the Defense Department and the FBI, so that they can investigate it and, if appropriate, the appropriate persons can be prosecuted.

Senator RUDMAN. Mr. Bonner, this is Warren Rudman of New Hampshire. Again, let me also say what my colleagues said. Your testimony has been an excellent summary. If the problem is as widespread in the country as you think it is in your district, the problem is far bigger than many have thought. I have two questions, both very brief.

First, I missed part of your testimony, in which you discussed one of the vice presidents of one of the contractors who did not take cash but took something else. What was that?

Mr. BONNER. I believe I was mentioning earlier that one of the employees, a managerial employee—and this is a fairly common scheme in corruption situations—had set up a shell corporation, which he controlled, for purposes of funneling kickback payments to him.

And we had another situation, which I didn't mention, which is similar, where a Raytheon executive, who had set up a "consulting company"—and I put that in quotes—for purposes of having kickbacks funneled to his consulting company, and where he was submitting phony invoices to the supplier that wanted the subcontract. So the kickback payments were paid by the supplier to this so-called consulting company that had been set up for essentially nominal or really phony services.

So you see different variations on kickback schemes. A lot of them, though, are just straight cash under the table kind of things.

Senator RUDMAN. Mr. Bonner, there have been a number of cases—I am sure you are familiar with some. I am familiar with many where kickbacks and commercial practices, not necessarily in the defense industry, were made with goods—automobiles, airplane tickets, vacations, things of that sort—which in some cases are easier to trace than cash.

Do you have any incidents of that in California?

Mr. BONNER. We have certainly had incidences of that. We have incidences of noncash payments. We prosecuted and convicted one individual who received kickbacks in the form of all expenses paid European vacations.

We have seen an instance in which a buyer at one of the defense contractors—apparently he already had a vacation to Europe and he wanted an automobile, and he demanded that he be paid his kickback in the form of an automobile that cost in excess of $12,000.

So we have seen the kickbacks take that form, also.

Senator RUDMAN. Mr. Bonner, one last question, and I ask this not because I necessarily think it ought to be done but just as a question to discuss with you in the brief time we have.

I am familiar with some commercial operations that have had large bribery and kickback problems, in which people who were in a position to influence those operations were asked by the management company internally without Government involvement to cooperate in a program of voluntary polygraphs. Once they put that into effect, the problem dried up because the threat of course was enormous.

What would you think of that idea being instituted by similar contractors themselves?

Mr. BONNER. I must say that is one I haven't given a lot of thought to. I would want to give some more thought to it.

I think the general principle is a good one. There unquestionably are institutional controls that can be implemented inside the prime contractors, the defense contractors, which would have the effect, in my judgment, of reducing and perhaps even terminating kickback situations.

There are all sorts of things that might be considered—a real system of having sealed bids, where the buyer that takes the bids isn't opening the bids. There is the possibility of rotating buyers so that don't develop long-term relationships with certain suppliers. The possibility of polygraph examinations periodically might also be considered.

These things might well be effective. I would certainly want to give it a little further thought before I wholeheartedly recommended the use of polygraph examinations, however.

Senator RUDMAN. I appreciate that. I think what we are all obviously talking about is—quite frankly, I have always believed that no matter how good the statutes are, if a problem is large you are going to get maybe the tip of the iceberg and maybe a little bit down the iceberg, but it is going to be a problem unless you find a way administratively to put a chilling effect on that particular kind of white-collar crime.

The question is: how do you have the chilling effect on kickbacks?

If you have any further thoughts on that, I know the subcommittee would be pleased to hear it.

Thank you very much. I will turn the telephone connection here back to our chairman, Senator Cohen.

Senator COHEN. Mr. Bonner, thank you for your testimony. We regret that you couldn't be here to join us with your colleagues today, Mr. Volz from Louisiana, who is eager, I know, to explain some of the things he has been doing as well. But we do appreciate your taking the time and getting up at such an early hour to make this presentation.

Thank you very much.

Mr. BONNER. You are welcome, Senator.

Senator COHEN. I might just say to the committee members, to outline exactly where we are going from here, that the purpose of holding the hearing this morning is to determine, first, the extent of the subcontractor kickback activity in the defense industry, second, the similarities among the various kickback schemes, third, the investigation and prosecution efforts undertaken by the U.S. attorney's offices, the FBI, and other law enforcement agencies to combat this illicit activity, and, fourth, the need for stronger laws to deter and punish those who engage in kickbacks. I have a more detailed opening statement that I have requested be included in the hearing record.

In addition to Mr. Bonner's testimony, we will be hearing from Mr. Volz, the U.S. attorney from the Eastern District of Louisiana, who has been actively prosecuting kickback cases, one involving Avondale shipyards in New Orleans.

I might point out that we are going to focus, at least initially, on a small item. It is called a welding tip. It is about a $20 item, not a

very significant piece of equipment, but it has been sold to Avondale, as I recall, for about $47—more than a 100-percent markup.

And I think that the committee and subcommittee members will be intrigued to see how much money in subcontractor kickbacks was generated out of just this one item within the shipbuilding industry.

We are not singling out Avondale for any particular special treatment. Avondale is but one of the contractors who has, in fact, been plagued by this problem. If the testimony we have heard to date is indicative of how pervasive the problem is, I think we will see that it affects almost all facets of the defense industry itself.

Avondale, since that time, has made a number of improvements, educational programs, along with Hughes Aircraft, and we will hear about that later as well as see what these companies are doing to try and prevent this problem.

So any reference to Avondale is by way of example and not by way of trying to single out any particular company.

Also testifying on the law enforcement panel will be two representatives from the Federal Bureau of Investigations, who will give us an overview of kickback scams currently investigated by the FBI.

A representative from the Criminal Division of the Justice Department will recommend changes to the Anti-Kickback Act, including prosecution efforts.

Similarly, we will hear from an aerospace company excutive to explain what his company has been doing to correct the kickback problem.

So I am going to welcome the panel here. First, Mr. John Volz, U.S. attorney for the Eastern District of Louisiana, Victoria Toensing, the Deputy Assistant Attorney General of the Criminal Division of the Department of Justice Jeffrey Jamar, the Section Chief of the White Collar Crime Division of the FBI, and Joseph Sheehan, who is the supervisory special agent for the FBI in Los Angeles.

Mr. Volz, I understand you made a special effort to get here, and we appreciate your doing so. We had hoped that Mr. Bonner might join you at the table, but extenuating circumstances prevented that.

But we are indeed looking forward to your testimony on the kinds of kickback activities that you prosecuted successfully in the Avondale case. We would be pleased to hear your testimony this morning.

TESTIMONY OF JOHN VOLZ,[1] U.S. ATTORNEY, EASTERN DISTRICT OF LOUISIANA (NEW ORLEANS)

Mr. VOLZ. I would have to distinguish, at least in part, from what my colleague, Mr. Bonner, said about his investigation, which seemed to be, from what I heard this morning, centering mostly on kickbacks. That is, the payment of money in return for the business. So in that sense, I guess you could say that the vendors were more in a position, possibly, of being a victim. But in the Avondale

[1] Mr. Volz' prepared statement, with an attachment, is on p. 57.

situation, we found, most pervasive, that the vendors were equally involved in thievery, as were the employees.

We found that if there is a new way to steal, the employees and the vendors at Avondale found it. There were many different schemes, from false invoices, by collusion between employees at Avondale, supervisors and vendors, to supplying false invoices that obviously made Avondale the primary victim and ultimately, the Federal Government, taxpayer, and some of the Federal contracts that Avondale had.

Incidentally, Avondale is a local shipyard that employs over 5,000 people. It is the largest employer in the New Orleans area. At the time covered by our investigation, Avondale was doing about 70 percent private work and about 30 percent Government contracts. Today I understand it is almost the other way around now. They are doing mostly Government contracts.

If you would turn this ledger [1] around, that is one example.

Senator COHEN. Would you explain the ledger.

Mr. VOLZ. Yes, I will.

One of the defendants in the Avondale investigation——

Senator COHEN. Could I interrupt. Perhaps you could paint a picture, in terms of how many employees are involved, at what levels? Were they simply vendors? Were they management? And perhaps give an overview of what took place with respect to this piece of equipment.

Mr. VOLZ. OK. To date, we have had 26 convictions. Approximately half of those were vendors and half were employees. The employees ranged from warehouse supervisor, chief purchasing agent, all the way up to a vice president. We had a vice president in charge of security, who, ironically enough, was responsible for starting our investigation, in the sense that he reported some thefts from petty cash to a local sheriff's office. The local sheriff's office became involved and indications were that it was a much larger operation. And they came to my office with it, and we, of course, got the FBI in on it, and the investigation started from that point.

He was ultimately charged with falsifying his income tax records, in terms of having given campaign contributions to various candidates for office, none of whom knew the source of the money, the source of the funds; the candidates thinking the funds were coming from the private pocket of the person that Avondale—in fact, the company—was being charged with, all the way to a vice president who had set up a corporation himself without the knowledge of anyone else inside of Avondale, or anyone who would say anything, and purchased items from his own company at very highly inflated prices.

As I say, a warehouseman in collusion with another employee from Avondale and a vendor, submitted false invoices to the company, totaling more than a quarter of a million dollars. Some invoices were paid twice.

Senator COHEN. For this item?

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[1] See p. 70.

Mr. VOLZ. Welding tips was the second major scam that they did. The welding tips were charged almost double. I am not certain whether this ledger relates to the welding tip scam or not. But this is the ledger of a senior purchasing agent for Avondale Shipyard, and he was in charge of purchasing the welding tips. The number 9507 is an invoice and the $37,550, that is a balance, let's say, that was owed by the vendor to, in this instance, a Mr. Chabert, who was the purchasing agent. The $290, and is it $540 underneath, that was what was owed on that invoice, which would have been approximately 10 percent of the invoice. The $102 and the minus $500 indicates a payment of cash, and you see that reduced to $3,780.

Senator COHEN. That is the vendor paying the purchasing agent?

Mr. VOLZ. Yes, that is the vendor paying straight cash to the purchasing agent. You see the next item, minus $600. That was a payment also. I can't make out whether that was the name there. But the next one you see there, La Louisiane, which is the same type of thing. That is also a payment. La Louisiane, if you are not too familiar with New Orleans restaurants, it is one of the better restaurants in the city of New Orleans.

What they would do, they would have credit cards that were supplied by the vendor, and they would go make purchases such as meals at a restaurant like this, deduct the amount and keep a running tab. See icemakers? That was another payment. He bought an icemaker and charged it to the vendor.

Senator COHEN. No coffee pots in there, are there? [Laughter.]

Mr. VOLZ. There may be; I don't know. The Plimsoll Club is a very, somewhat exclusive club, connected with the auto industry and the shipping industry; $150. I am sure that was charged to the Plimsoll Club. And it is just pages and pages.

Senator COHEN. You've got a couple of other entries. One is a VISA. Is that a similar type of charge?

Mr. VOLZ. Yes, sir. In other words, that VISA would be the VISA that Mr. Candler, in this case, the vendor——

Senator COHEN [continuing]. Is giving to the purchasing agent.

Mr. VOLZ. Right.

Senator COHEN. Then you've got Profax. What does that mean?

Mr. VOLZ. Profax actually is a mistake here. One of the things that they did was to make the bidding process—not the bidding process, but the purchasing process in a way that it would have to go to certain vendors. They would put names, invent names like Profax, and they said that this particular—let's just say the welding tip is Profax. So that way, Profax would have to be audited. In fact, it was not Profax in this case, but Mr. Chabert got mixed up with another vendor, who was kicking back to him. And he put the wrong name down.

Senator COHEN. Just so everybody will understand it, this is a sheet taken out of a kickback book that was being maintained by the purchasing agent for the shipyard.

Mr. VOLZ. That is correct.

Senator COHEN. And as I understand it, he maintained this black book with the notations and actually turned it over to the vendor to show him he was keeping accurate records as to how much he still owed.

Mr. VOLZ. Exactly.

Senator COHEN. So that the vendor could take a look at this black book and say, "I still owe you $36,828."

Mr. VOLZ. Exactly.

Senator LEVIN. While we are on the subject of black books, why do you think he kept that black book?

Mr. VOLZ. I think he kept the black book, frankly, Senator, because he had so many schemes going that he had to keep track himself, and he wanted to be sure that he didn't come out on the short end of the stick. So he had to keep records, so that he would be able to say, you owe me this, and I've got it written down here. You gave me $500 this day, and I bought an icemaker this day. You have to understand, there's more than one vendor that this man is doing business with.

Senator LEVIN. Is this the same man who asked for a promissory note from one of the vendors, in case the vendor died, so that this guy could actually go against the estate of the vendor?

Mr. VOLZ. I don't know if it was this one, but that did occur.

Senator LEVIN. That did occur in one of these cases?

Mr. VOLZ. Yes, sir.

Senator LEVIN. That is just how blatant it is.

Senator COHEN. Let's step back for a minute and trace how this kickback problem apparently started up of Avondale focusing on the subcontractor who sold these welding tips out of the back of his pickup truck to the company. How did this balloon?

Mr. VOLZ. I am not sure I understand what your question is, Senator.

Senator COHEN. I am told that the supplier whose kickbacks are documented in this kickback book originally sold welding supplies to Avondale out of the back of his truck and paid kickbacks of 2 or 3 cents for each pound of supplies that he sold to Avondale. That is how it began. Within 5 or 6 years, the ante was raised to the point where this supplier provided the purchasing agent with unlimited use of credit cards, annual trips to Las Vegas, and occasional trips to Hawaii.

It went from 2 to 3 cents a pound to credit cards.

Mr. VOLZ. That is correct, Senator, that is what it lead off.

Senator COHEN. And that led to the purchasing agent asking for a promissory note, because the supplier owed him so much money that he wanted to go against the supplier's estate in the event he was hit by a car.

Mr. VOLZ. That's the best example of greed. What started off as a very almost not organized, in a sense, just sort of well, I'd appreciate the business here. Here's $100. And they started to think, well, if I can get $100, maybe I can get $500. And then they began to develop these various schemes.

As you pointed out, the company, Avondale, itself was a victim, to a large extent. We would have, as Mr. Bonner said in his cases, we would like to have seen them come forward earlier with the problem, but I do believe that they have made significant changes in their own structure. They were bilked to the tune of over $5 million. To date, we have established that the Federal Government, the taxpayers, were bilked for more than $1 million and $439,000 in interest, really, on that money.

To date, there has been restitution made. That has been one of the requirements on all these sentences that have been handed down. Restitution has been ordered, is being made. Avondale has credited the Government with the million plus that we have established—the DCAA has established to date and has also made the interest payment. Quite frankly, no problems, I'd have to say that, for the company. So that, as we demonstrate, "we"—I use the term—the investigative agency, includding DCAA, establishes the amount that the Government has been overcharged and charges have been made to Government contracts, that they have made those good, and of course, we consider that to be as much a responsibility as providing a deterrent to this kind of activity, because if there is any area that deterrence counts, it would be in this area that deterrence would have an effect, is white-collar crime, with monetary profit. These people are calculating, and I think they think of the odds of getting caught before they do these things.

Senator COHEN. Basically, you had a scam or a scheme, whereby you take this item, let's say it's worth $20. The supplier sells it to the purchasing agent for the company for $47. Out of that price there is a kickback that is paid out of the profit. There are also cases in which these are ordered and then never delivered.

Mr. VOLZ. That is right.

Senator COHEN. There is an invoice delivered. We delivered so many of these widgets to you and billing you *x* amount of money, and they never receive it.

Mr. VOLZ. In some of the cases where items are stolen from Avondale's inventory, sold at discount and then repurchased by the company.

Senator COHEN. As a matter of fact, it goes even further. In some cases, purchasing agents take whatever equipment might be obsolete and unnecessary and sell this as salvage. The suppliers then will turn around and resell it to the company at a substantial markup. Isn't that correct?

Mr. VOLZ. That is correct.

Senator COHEN. That was done in Avondale, as well.

Mr. VOLZ. Yes, sir; that is correct.

Senator COHEN. We have the example of this one individual who was doing it with respect to welding tips, but he had a whole lot of other supplies, did he not?

Mr. VOLZ. Yes, he did.

Senator COHEN. It wasn't just welding tips. He was involved in cracking every facet of the shipbuilding business.

Mr. VOLZ. That is correct.

Senator COHEN. How much money was he taking in?

Mr. VOLZ. The fellow with this book probably, I think, in the neighborhood of probably $300,000 to $400,000.

Senator COHEN. Tax free.

Mr. VOLZ. Obviously.

Senator COHEN. Mr. Jamar is going to testify shortly that in southern California or central California they had a cluster of major defense contractors and with that a cluster of subcontractors. You do not have the same situation in Louisiana, where you have one major defense contractor.

Is the problem nonetheless as pervasive when you don't have a large number of subcontractors?

Mr. VOLZ. I think it is obviously pervasive at Avondale; however, you know, I can't say what it is in other parts of the country, but I can say that these same people were dealing with other defense contractors. So you would assume that if they are carrying on this kind of activity at Avondale, they are carrying it on elsewhere. And so, in that respect, yes. Of course, we find this not only in the defense industry, not only in the Avondale situation, we have other instances of similar activity with private corporations outside of the defense contract area, as well.

Senator COHEN. One final question, and then I will yield to Senator Levin.

In all the prosecutions at Avondale, did you use the Anti-Kickback Act to prosecute these people?

Mr. VOLZ. No, sir, we used the mail fraud, fraud against the Government. We felt that those statutes were more easily applied to the situations that we had, and I do believe there is some need for amendment to the kickback statute, and I think Ms. Toensing is going to respond to that.

Senator COHEN. Senator Levin.

Senator LEVIN. Thank you, Mr. Chairman. Thank you, Mr. Volz, for your special efforts to get here this morning. Others have also made those kind of efforts, but we know what you went through to get here.

Mr. VOLZ. Thank you, sir. My pleasure being here.

Senator LEVIN. In the Avondale situation, how many different subcontractors were involved? Did you use the figure 14?

Mr. VOLZ. I think it was 12. See, the 14 employees and 12 contractors, or just the opposite. But it is almost half the 26.

Senator LEVIN. We are talking then about a dozen different subcontractors that were paying kickbacks to Avondale employees?

Mr. VOLZ. Yes, sir, kickbacks and also helping them to steal.

Senator LEVIN. And there were about a dozen Avondale employees that were involved also?

Mr. VOLZ. Yes, sir.

Senator LEVIN. Is it true that the defendants in your case indicate that their predecessors at Avondale, in the same positions that they were holding, had also engaged in those type of activities and that they continued this tradition of kickbacks?

Mr. VOLZ. Yes, that is correct, and that is, I think, a very important point to be made, that it was so pervasive, the dishonesty throughout the company, that while they were not all involved in the same schemes they knew of the schemes and they would ignore them because they had their own, and it was a way of life.

Obviously, it had been going on for years beyond the statute of limitations, so that we could not go back and prosecute anybody else.

I think it is also important to point out that not only was the amount of the kickback added to the price in those instances where actual goods were delivered, not only did they inflate the price of the 10 percent, but they would inflate it maybe 20 percent so they could get half of that back.

So the vendor was making it both ways.

Senator LEVIN. Now, I would like to ask you about what management knew here. Not because we are trying to indict the management there at all, but to illustrate what some of the problems are in rooting out this kind of cancer and the instincts, what Mr. Bonner called the human nature instincts of management, are when they first suspect something.

As I understand it, there had been an internal audit at Avondale prior to your investigation which showed excessive use of welding material, is that correct, sir?

Mr. VOLZ. That is correct, sir.

Senator LEVIN. It was something that made management suspicious about 6 months prior to your investigation, is that right?

Mr. VOLZ. That is correct, sir.

Senator LEVIN. Did they bring that to your attention prior to your investigation?

Mr. VOLZ. No, sir, they did not. That is one of the problems that I would have to say we encountered with the company, and again it is perhaps a natural reluctance for them to bring down—let's face it, to be candid—bad publicity of having that kind of scandal come out.

I think once the scandal was out that they did as much as they could to assist us, and as I said before, they made some significant changes in their internal procedures. But they could have been a little more cooperative.

Senator LEVIN. Now, as I understand it, there was an accounts payable supervisor at Avondale whose employment was terminated with Avondale because of certain double billings with an Avondale vendor.

Mr. VOLZ. That is correct.

Senator LEVIN. His employment was terminated about 6 months prior to your investigation?

Mr. VOLZ. That is correct.

Senator LEVIN. So that the instinct, perhaps a natural instinct, of the prime contractor here was to get rid of the problem?

Mr. VOLZ. Exactly, handle it themselves.

Senator LEVIN. Take care of it themselves.

One of the things which our legislation is going to address is exactly that. We have got to make it more likely that when prime contractors are suspicious that they notify the Defense Department, and as Mr. Bonner indicated, if that in turn leads to other evidence, the proper authorities would be notified.

It is critical that we do that because we have got to overcome that natural instinct, which is just simply to get rid of the problem instead of to bring the problem to our attention. So that we can recoup and we can deter and we can make sure that people are punished where it is appropriate for violating the law.

Mr. VOLZ. It is certainly no secret, Senator, that in the art of white-collar crime—and I am sure the FBI can address this—it is not like discovering a dead body and then trying to find out the perpetrator. The real difficulty in many cases is to determine that the crime has taken place at all, and of course this is where some kind of internal monitoring along with some kind of obligation to report that to the authorities is found.

Senator LEVIN. Now, there are certain presumptions of innocence that this country thankfully engages in, and there are certain rights of privacy which this country thankfully protects, and the instinct of the primes is based, to some degree at least, on those beliefs that the employees have not been found guilty criminally and that there are certain rights which they are entitled to. There is no presumption of guilt.

In order to try to give the employer a justification for at least notifying us where there is suspicion, we are going to have to place a requirement on that employer to do so. Otherwise, those other protections would probably prevail. That is the reason for looking at that particular provision as a way of putting a requirement on an employer so that employer can say, look, I notified the Defense Department of my suspicions because I was required to do so under my contract with the Defense Department.

One last point. The greed, as you call it, which it obviously is, which led to this kind of an activity where there is a blatant taking of illegal payments, soliciting of illegal payments, is so open in this situation and others that it is proof of the fact that it is a way of life.

The only reason—the main reason I emphasized, for example, that promissory note from a vendor—is exactly that.

It is so pervasive, what is happening, that people apparently think that it is stylish to get written evidence from somebody that a crime has been committed by the person soliciting the written evidence. It is incredible to me that this has come to this point. Where somebody who is soliciting an illegal payment and obtaining illegal payments is actually asking for a promissory note from the person from whom he is extorting those payments, in case that victim dies, so that he can go after the victim's estate.

That is where we have come, and that is what we are going to attack. That kind of an attitude, which is so pervasive apparently, that at least some of our law enforcement people think it might be as much as 50 percent in their particular district of the employees that are in these positions are involved in this kind of activity.

Mr. VOLZ. The point you make there, Senator, is something that we observed in the number of contractors involved and the obviousness of many of these schemes and scams to other people in the business.

They also suspected these things were going on. The legitimate business people, legitimate subcontractors apparently stayed away from Avondale because of that. They knew that these things were going on, yet no one came forward.

That is unfortunate.

Senator LEVIN. Thank you, Mr. Chairman.

Senator COHEN. Senator Rudman.

Senator RUDMAN. Mr. Chairman, I will be brief.

The last thing the witness said in response to Senator Levin's question raises an issue that is quite separate from the issue that we are discussing here.

Senator Levin and Senator Cohen both serve on the Armed Services Committee. Coincidentally, I serve on Defense Appropriations. So we are looking at the whole defense problem.

We talk about, to quote you, legitimate vendors who stayed away from Avondale. Mr. Bonner said almost the same thing about what was going on in California.

Here we have a history in the last 6 or 7 years of spare parts failing, of original parts within systems not working, of a number of scandalous items that have to do with how the specifications work or don't work, and I think this is an issue that has to be explored beyond the expertise of this panel of witnesses and certainly by the Armed Services Committee and maybe the Defense Appropriations Subcommittee.

The question really is: Is this so pervasive that highly qualified vendors who want to make a high quality product at a fair price cannot, in many cases, get the amount of business that they ought to get because the business is going to people not on the basis of quality but on the basis of who pays bribes?

Mr. Chairman, I think it is a very important issue and one that really ought to be followed.

Senator LEVIN. And the drama of this morning's hearing in part is "Mr. Smith's" unwillingness to come here because of the risk that would be involved for him as an honest vendor. He was our honest vendor.

Mr. VOLZ. If I might add something to what Senator Rudman said about the legitimate businessmen not wanting to get involved.

One of these schemes involved a testing of parts. They rated only two kinds of parts that were good enough to be utilized. This is with welding wire. There were only two approved for testing, and both of those were from the favored vendor.

Senator RUDMAN. Was there any evidence that they were quality control people, whether they called them that or not, who were in collusion with the purchasing people?

Mr. VOLZ. Yes, sir, they were in collusion.

Senator RUDMAN. They were in collusion. That gets to be a very serious problem because, obviously, in a large corporation QC is separate from purchasing. If somebody buys a spare part and pays the bribe, somebody is going to catch it. If you get collusion between those two elements of the company, then you have lost it, and the airplane crashes or the missile blows up or the submarine sinks or whatever.

Mr. VOLZ. I am not suggesting that that was the case for these parts, but it just shows you that that can happen because there was collusion there.

Senator RUDMAN. Mr. Chairman, I know we have got a lot to do, so I am not going to ask another question. I want to just say something also along the lines that Senator Levin said.

I hope nobody loses sight of the fact that we have got a remarkable thing happening here. I have served on this committee and the subcommittee investigations of people involved with the Mafia, with drugs, who sat here and were protected by U.S. marshals, by screens, and never once did we have someone refuse to testify, even those whose lives were threatened.

For the first time we have got a witness who is so in fear for his well-being, his economic future, his life, that he is afraid to come to sit before a committee of the U.S. Senate.

That says a great deal about this problem, and I commend the chairman for holding this hearing. I think we are going to have a lot to do with this issue in the months to come.

Senator COHEN. Thank you, Senator Rudman.

Jeffrey Jamar, who is the section chief, White-Collar Crime Section of the FBI, will be our next witness.

Senator CHILES. Mr. Chairman, could I just put an opening statement here?

Senator COHEN. Senator Chiles.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. I regret I couldn't be here for today's hearing, but I do want to compliment you and Senator Levin for your efforts regarding this hearing and the investigations into the allegations of contract fraud.

Certainly if these allegations are correct, then some legislative improvements have to be made in the antikickback law, and I want to publicly pledge my efforts to whatever legislative improvements the subcommittee decides.

Seemingly, two other very important laws are being distorted and exploited in this illegal kickback scheme. Both were designed to enhance business opportunities for small business firms. Both came out of the Governmental Affairs Committee.

The first provided for simplified small purchase procedures for contracts of $10,000 or less. There was good reason for that law. It eliminated a lot of needless paperwork and increased the number of small firms doing business with the Government.

Certainly that law was not designed to eliminate or decrease control factors in the procurement process. If necessary, we may have to do some legislative tinkering with that law to ensure that we maintain competition while we also ensure proper controls.

Second, the Congress passed Public Law 95-507 to again provide for increased competition amongst small business firms doing business with the Government. In fact, the comprehensive subcontracting plan was considered part of the law.

It is distressing, Mr. Chairman, to learn that these noble intentions of Congress to provide increased business opportunities for small business firms have also increased opportunities for rip offs to occur.

Again, I pledge my support to your efforts and the subcommittee's efforts, and I look forward to participating with you.

Senator COHEN. Thank you very much, Senator Chiles. I might point out one irony in all of this.

Back in 1979, I had occasion to travel with Senator Hart, Senator Nunn, and Senator Glenn to the Far East to meet not only with the leaders of the Chinese people but other countries as well. We had occasion to meet with a group of major business leaders in the Far East, as well as American business leaders.

One of the things they had recommended to us as legislators was that we repeal the law that prohibited them from giving bribes to foreign governments because they couldn't do business. That was the way of life over there, that if they weren't willing to kick in *x* amount of dollars they couldn't get any contracts.

Our response was unanimous. We said that was un-American, and we don't believe in that sort of thing. One of the ironies here today is that we are finding out that what we considered to be un-American is taking place right in this country.

Mr. Jamar.

TESTIMONY OF JEFFREY J. JAMAR,[1] SECTION CHIEF, WHITE-COLLAR CRIMES SECTION, FEDERAL BUREAU OF INVESTIGATION, AND JOSEPH SHEEHAN, SUPERVISORY SPECIAL AGENT, LOS ANGELES DIVISION, FBI

Mr. JAMAR. Mr. Chairman, members of the committee, I'm pleased to be here to discuss the FBI's experience with subcontracting in connection with defense contracts.

Special Agent Sheehan is here from Los Angeles. He participated in the investigation described by U.S. Attorney Bonner. He has also participated in discussions and presentations to various defense contractors to heighten awareness of the problem of subcontractor kickbacks.

Within the FBI's investigative programs we all know white-collar crime has a very high priority. In recent years, we've adjusted priorities within the white-collar crime program to make Government fraud connected with Government programs and procurement the highest priority within that program; along with the inspector general in the Defense Department and the various investigative agencies of the Armed Forces.

We have worked very closely together in establishing the ability to put cases together to address this problem. Our experience is that cases are generated from geographical areas that contain, like southern California, clusters of prime contractors, which have generated clusters of subcontractors.

We also have several cases in New England and the Midwest. One exception to this type of case, where it's not clustered, is the one described by Mr. Volz. This clustering enables the first-line buyer, the person that seems to have the best means of obtaining kickbacks, to create circumstances by bringing in several vendors, bringing them together, where he can control their activities.

You ask why do they do it? Their salaries are, from our experience, $25,000–$50,000. Why would they need more money? They have this system of kickbacks with percentages geared to the face of the contract. Our experience is that it varies from 2 to 10 percent. We have one case that is right on the money, 6 percent. But the amounts of money it has generated ranges from where, we think, they can enhance their incomes to $50,000–$100,000 a year and, in some cases, more than that.

And what kind of contracts lend themselves to kickbacks?

Contracts that are most vulnerable are those similar to the ones described with the welding wire, where there's a specific specification that they're able to control completely.

In such instances, we've had a case where an engineer was able to design an item, whatever they were after, where it had to be manufactured. When it has to be manufactured, you end up with

[1] Mr. Jamar's prepared statement is on p. 75.

unknown costs, and unknown costs lead to contracts such as the bump described by Mr. Bonner.

The means of disguising kickbacks varies. The simplest one is decentralized purchasing, where the buyer controls which records are generated. That makes it simple. The vendor builds it into, or the subcontractor builds it into, the bill to the prime contractor.

Others create false companies, have false billings—totally false. There's nothing there.

Another means of furthering the system is bid-rigging. The bump is a good example. We had one case where the company submitted three bids—their own bid, a bid of a totally fictitious company, and the bid of a company that had no idea that the bid was being let.

We have discussed top management. How and where are they the problem?

It's very difficult for them to know. They find out through the disgruntled employees or persons who are tired of the system. They find out through audits such as those done by the Defense Department; and they find out from other cases like they found out about in the case that we had in New Orleans.

It's something that's very difficult for companies. We wonder if they want to spend the money to put the audit procedures in. It's very expensive to conduct unscheduled audits. So that the buyers are able, because it's decentralized, to control the environment. They can create an environment where it appears to be competitive.

As we discussed earlier, in the past, and hopefully, not so much in the future, when companies discover an employee who is taking kickbacks, they fire him. They rid themselves of him.

No prosecution follows. The thoughts behind that are that the companies do not want the publicity that comes with a scandal like they had in southern California. They don't want to subject themselves, the company, to indictment, possible suspension from doing business with the Government, or debarment from doing business with the Government.

What's happened is someone is fired from one company in these cluster areas and seeks a job elsewhere in the industry. We have encouraged companies to participate in industry education programs.

What we've done—we've done them ourselves—what we've done is made ourselves available to help them, to add our expertise to whatever problem they want to discuss.

A lot of companies have taken quite a few steps such as Agent Sheehan has participated in. I think it takes at least that.

What does it cost overall? What is it costing the Government for these contracts?

Our experience shows the kickbacks are 2 to 10 percent. There's more than that. It's built into the base. It carries all the way through the contract from the prime contract to the subcontract. And it's our experience and our belief that it's costing us more than money.

Corruption deteriorates the system. Someone says, Everybody's doing it, I'll join in. What else will they sell? Will they sell quality control? Will they sell secrets? What else will they give away?

We're going to keep our resources where we can. We're going to keep trying to identify these people. It will depend on the future availability of prosecutors, investigators and also concentration by the Department of Justice in those type of cases that they'll be able to prosecute. It's something that I think is required in almost every phase of our investigations.

We have to cooperate with others. We have to learn from others, such as the Defense Department. We have to learn how contracts are drawn up, how bids are let. We have to work together. And we've made quite an effort, created several teams, several joint investigations with the Defense Department and the Armed Forces.

That concludes my comments. I'm happy to answer questions.

Senator COHEN. Thank you very much, Mr. Jamar. I'd like to direct questions to Mr. Sheehan.

The subcommittee has a tape provided by the U.S. attorney's office in Los Angeles of a conversation between a supplier whom the FBI had wired and a buyer from the Northrop Corp. who had been convicted of taking a kickback.

I understand you were very much involved in this investigation. I'd like you to give us some of the background before we play the tape.

Mr. SHEEHAN. Yes, Senator. In November 1983, in the Los Angeles Division of the FBI, I handled the investigation, looking at allegations of widespread kickbacks and bid-rigging schemes in the aerospace industry in southern California.

One of the individuals that we identified very early on as being a participant in this type of a program—bid-rigging and kickbacks—was approached. We initially gathered some evidence. We talked to this individual and this individual agreed to cooperate with the FBI.

His degree of cooperation was that he would wear a concealed body recorder in further contacts that he had with individuals who were employed by the prime defense contractors in the procurement function.

These individuals that were employed by the prime contractors had in the past demanded kickback payments from this particular individual in order to allow that individual to get any of the business.

This individual owned a machine shop in southern California. Most of what he was selling to the prime contractors were machine parts that were designed and manufactured either by himself or for inclusion with other subcontractors. When I say "inclusion," I don't mean that in the negative sense.

The undercover meetings began in very early 1984. His role in the case basically ceased about 8 or 9 months ago. The overall investigation is still continuing. There is still an investigation into additional buyers for the prime contractors who are involved in these kickbacks and bid-rigging schemes.

We are also looking at other subcontractors much like this individual who cooperated with the FBI, who are making kickbacks and payoffs to prime contractors.

So far, this particular investigation has resulted in indictments, and I should say convictions really, we had five indictments in five incidents which led to information.

We've had a total of 10 people convicted so far in Federal court as a result of this particular investigation. The tape recordings that you are about to hear are composite tape recordings of several different conversations that the cooperating witness had with a buyer for a prime contractor.

In this particular instance, the prime contractor was the Northrop Corp. The meetings took place in restaurants. Many of the meetings that were on the recording as a result of this investigation were cocktail hours. Some of it took place in business offices.

And I think that when you listen to this recorded conversation, you'll get the flavor for the types of things that we uncovered and are continuing to discover is somewhat, unfortunately, an attitude on the part of some of the people who are employed by aerospace in southern California.

Understand that this only applies to southern California. I can only speak about southern California. That's my so-called area of expertise. I don't know what's happening in other parts of the country, but we certainly do have a problem out there and we recognized that before. We are more convinced of it now than ever, that we have problems in southern California, based on the results of, as Mr. Bonner mentioned, well in excess of 100 hours of tape recorded conversations that were made not just by this one particular individual, but by other individuals who cooperated with us and literally wore the tape recorders while they were negotiating these kickbacks and payoffs. And in many instances, wore the tape recorders while they were making the kickbacks and payoffs.

Senator COHEN. Why don't you proceed playing the tape recorder?

Senator RUDMAN. May I just ask a question, Mr. Chairman? First, speaking of Northrop, what rank? What level is that person?

Mr. SHEEHAN. He was a procurement administrator. He supervised a group of buyers. He also would do some purchasing on his own with certain types of subcontractors, as you will see here.

Senator RUDMAN. He's been convicted?

Mr. SHEEHAN. Yes, he has been convicted.

Senator RUDMAN. What was the sentence?

Mr. SHEEHAN. He was sentenced to 3 years imprisonment, 5 years probation and restitution.

[Tape recording played.]

BROUSSEAU. OK, sure. The arrangement that I have with [name deleted] is a, is a nickel. OK? And if you should come up and say, let's say you look at a job and you conceivably see that let's say it's worth, uh, the arbitrary figures. Let's say a hundred bucks a part. OK? And I come back to you and I say OK your bid was really good at a hundred bucks. I'd like to give you $175 for it.

HASKELL. Uh-huh.

BROUSSEAU. OK now. I'm gonna bump it $75. The $100 price that you originally bid was a good bid.

You know? In your eyes.

HASKELL. Uh-huh.

BROUSSEAU. It was a small profit job for you.

HASKELL. Uh-hmm.

BROUSSEAU. OK, I'm gonna bump it $75.

HASKELL. Uh-hmm.

BROUSSEAU. OK, what I would like is I would like 25 percent of the $75 bump. You keep the other 75 percent.

HASKELL. Uh-hmm.

BROUSSEAU. You know.

HASKELL. OK.

BROUSSEAU. And that seemed like an equitable position.

HASKELL. Uh-huh. So it's, it's 5 percent on the $100, and——

BROUSSEAU. Five percent straight and 25 on a bump.

HASKELL. OK.

BROUSSEAU. To your health.

HASKELL. To your health, Ron.

BROUSSEAU. We are so, into such an infancy, in the ground floor of this program, that I firmly intend to—I'm 44 years old right now—I firmly intend to retire at 55.

HASKELL. Uh-hmm.

BROUSSEAU. And if I just take a little piece here and a little piece there and a little piece there, put 'em in a shoe box and bury 'em in the back yard.

HASKELL. And don't get greedy.

BROUSSEAU. And don't get greedy, you know a nickel here and a nickel there. Everybody's gonna get fat. Everybody's gonna be happy and at 55 I'm gonna say "goodbye guys." I'm gonna buy my little cabin and my fishing boat on a river and then [unintelligible].

HASKELL. There you go. That's good.

BROUSSEAU. It's people that get greedy are the people that get caught.

We don't have any heads, we don't have any supervisory people. I report directly to my manager. I have, right now I have four and I'm soon to have two more buyers working for me. All the work that comes down whether it'd be machining or tooling or machine parts or processing or any of that stuff—fabrication of any kind—comes to my desk. It comes down in big packages, to the manager's desk. The manager says this is fab, this is fab, that's electrical, this purchase parts—and he brings a stack of stuff over to me and he gives it to me. And he says, here Ron keep your other—keep your people busy. So I take what I want, I give them what they want. Or what I want them to have. Nobody—nobody questions dollars or anything like that. As long as I can show competition whether it's true competition or courtesy competition or bullshit competition, you know. That's all I gotta be able to show is competition.

And one of the things that we're getting right now is we don't have any in-house estimates, and we won't have for a year and a half, two years until we have made some of this stuff. So when they come down and they say, hey we need a tool like this made; I say, OK, what do you guys think it would take to make it? Well, we think maybe 200 hours of machining. OK. What's our in-house rate? Seventy-seven dollars an hour. OK, multiply 200 times 77 to give me a not-to-exceed figure. That's what I work from. So if it comes out to a $100,000, if I can get that tool made for $80,000 I'm the best guy. I just saved twenty grand. OK? By the same token you can look at that job and say I can make that thing for $55,000.

HASKELL. Then you would look like a real hero, and you can play in between.

BROUSSEAU. But I'm not gonna let you have it for 55, I'm gonna at least let you bid it up to 65 or 70 because I know I'm budgeted for 100——

HASKELL. Uh-hmm.

BROUSSEAU. And I've got other competition that's coming in at, at 75, 80, 82.

HASKELL. So everybody looks good. We make money—you look good.

BROUSSEAU. Right.

Senator COHEN. Mr. Sheehan, the Democratic Party has a thing called the 500 Club. The Republicans have a thing called the Senatorial Trust, maybe the Thousand Dollar Club.

Well, there's something called the 10-percent club out in California. What's that?

Mr. SHEEHAN. Senator, the 10-percent club was first identified to me about 5 years ago by the Defense Contract Audit Agency auditor. Since then, it has been mentioned to me by people in the aerospace industry itself.

Basically, the 10-percent club is a group of people who may know each other, or may not know each other. They're engaged in procurement in aerospace. They may be buyers, they may be subcontractors. Basically, the understanding is that if you're going to do business with the particular buyer who is in the club, that buyer will require you to ante up 5 percent of the face value of the con-

tract at the time the contract is let, with an additional 5 percent of the face amount of the contract at the time that performance has been completed, or the time that the contract price has been paid.

Senator COHEN. Have you been able to penetrate this club? Do you know who the members are?

Mr. SHEEHAN. We've put 10 of them in jail so far, yes. When we say "club," that's almost a monicker. They don't have regular meetings or anything like that. [Laughter.]

It's a term that we've hung on them. I'm not sure any of them would want to regard themselves as part of a club, but we use it to identify these types of characters that generally understand what the market will bear; and the market will bear in southern California, 5 percent up front, 5 percent out back. So it's the 10-percent club.

Senator COHEN. You indicated, Mr. Jamar, in a portion of your written statement that it's virtually impossible to detect kickbacks simply by looking at paperwork, that you have depended generally, I assume, on subcontractors or vendors coming to you and saying here's what's going on.

Mr. JAMAR. It's very difficult for an auditor to pick out fraudulent billings. It's very difficult. So it takes someone inside to help us. It takes the industry itself looking at itself. It knows what its systems are better than anybody else.

These kind of things I wish were common, with overwhelming proof of intent to the jury. These people are much more subtle than that. False billing and payments are hidden all the way through the system. There's nothing there obviously that cash comes from, particularly in the bump. They know it's $75, but you can't tell it from the records.

Senator COHEN. Does the FBI go out and seek out various suppliers? Do they come to you? If they don't come to you, I assume you're out?

Mr. JAMAR. Yes. We can't investigate—we need some specific information for us to approach a certain subcontractor or a certain prime contractor. We know there's a crime problem. There's a huge crime problem in certain parts of the country.

What we're doing is we're making an effort to educate everyone we come in contact with, and to establish close liaison with Defense contractors, between Defense contractors and our own Defense Department auditors.

In fact, the Defense Department itself is making an effort to make themselves more aware of fraud where their auditors are much more intent on finding fraud.

Senator COHEN. If you have a conspiracy between the vendor and the purchasing agent, the kickback costs, I assume, won't be detected?

Mr. JAMAR. As long as they remain friendly.

Senator COHEN. Mr. Jamar, Senator Rudman asked about the sentence in one particular case, but there was one case involving a Raytheon program manager who was convicted of receiving over a quarter of a million dollars in kickbacks and was given probation.

Is that unusual? Is that symptomatic of part of the problem?

Mr. JAMAR. I think it's not unusual in certain white-collar crimes. Our approach has been we're not going to eradicate the

problem. What we want to do is increase the risk. We want to make it harder to make that $250,000.

A lot of people just don't think, unless there's some violence or some great harm to someone, that people deserve long prison sentences.

So I think that, in addition to being sent to prison, greatly increased fines, restitution, treble damages, are ways of overcoming judges who don't want to give someone jail time.

Senator COHEN. The problem is, I think, as Senator Rudman pointed out, it's not just white-collar crime. You're not just stealing money from the taxpayers. You, in fact, are perpetrating a system which, because of limited competition, if you're not in the club, you don't pay the bribe or the extortion price, you start to narrow the competition down. So you have sole-source contracting. You don't even have parts delivered, in some cases. In other cases, they might not be quality controlled.

You have a shuttle disaster, an airplane crash, a tank that doesn't work, and on and on and on. And especially if you're talking about the national security of the country. So it's not just somebody ripping off money for which they could get light sentences.

You're talking about jeopardizing, potentially jeopardizing the security of this country. So it's far more serious than just stealing a little money off the top. That's a minimum, but it goes much deeper than that.

So we have to increase the penalties. And, somehow, that message has to go through, either by way of legislation, or somehow get the kind of judges that will put people in jail for some length of time.

Senator Levin.

Senator LEVIN. In part of your written statement, Mr. Jamar, you said the following:

> The FBI has noted a pattern in which major violations involving subcontractor kickbacks develop in geographic locales where Defense contractors are clustered. The clustering of major contractors naturally attracts a similar grouping of subcontractors. The proximity of these components in the procurement process facilitates the development of kickback schemes. Significant problems have been identified in New England, the Midwest, southern California, and other areas.

That makes clear that the problem we're talking about here is a widespread one and, geographically, it's not located in just one particular area or another.

Is that a fair statement?

Mr. JAMAR. Yes. The statement is based on where the cases are coming from. The cases we're investigating right now.

Senator LEVIN. Also, in your statement you make the following point, that law enforcement is frequently not notified because of the fear of adverse publicity, which you also made reference to in your oral testimony, and the possibility that such reporting would subject the company to indictments or suspension from the market for doing business with the Government, which I think you made reference to as well.

The next line in your written testimony I think is very significant because you just made reference to it in your summary:

"Prime contractors were reluctant to notify other companies of kickback suspicions because of perceived liability issues."

And I take it that is your testimony and your experience, that there is a perception on the part of the primes that they would have some liability imposed upon them if they informed other companies in the area of their suspicions.

Mr. JAMAR. Also, if I am the suspect employee and you make a statement to other persons in the industry that I am stealing, without any proof, you just say it. So by rumor I am eliminated from employment in the industry.

Well, it goes back to the first part. If you don't want the publicity, either you are going to publicize the fact that there is theft in your company or if you don't publicize it, then pay me.

Senator LEVIN. So where we have an employer who is suspicious but doesn't have proof—to prove a crime, for instance, that level—but just simply suspicious of wrongdoing on the part of the employee, the instinct is to push that employee out the door?

Mr. JAMAR. Yes.

Senator LEVIN. And the instinct is not to tell subsequent employers about it because they are suspicious and there is not adequate proof?

Mr. JAMAR. We are hopeful that attitude is changing.

Senator LEVIN. But that is the kind of change we ought to try to promote?

Mr. JAMAR. Yes, sir.

Senator LEVIN. Then you go on to say, "Frequently, these corrupt employees have been reemployed within the industry."

Mr. JAMAR. Yes, sir.

Senator LEVIN. One question of Mr. Sheehan, and that is there is reference on this tape to a "nickel."

What does that reference mean, a nickel? Is that really a nickel, 5 cents?

Mr. SHEEHAN. It is 5 percent, Senator. In the tapes that we recorded in southern California we heard references to nickels and dimes. The dime would be 10 percent up front; the nickel would be 5 percent.

Senator LEVIN. In this tape we heard the person talking describe competition, and here is what he said. He says now, the buyer, "as long as I can show competition"—I am now reading from a transcript of the tape. It was hard to hear, but it has been transcribed—"As long as I can show competition, whether it is true competition or courtesy competition or bullshit competition, you know. That's all I gotta be able to show is competition."

I take it that you would agree that as much as we try to promote competition as a way of driving down costs that it is critically important that we go behind the appearance of competition. The mere fact that there is an appearance of it doesn't mean there is competition.

Is that a fair statement?

Mr. JAMAR. I think it can create the record systems. You know the courtesy bidding that you were referring to. It shows three or four or five bids, sealed bids, that show either higher prices or the bidding company is not competitive for some reason. It is there. The five bids are there. Without knowing what is behind it, without being able to have someone inside tell you, you are not going to detect that with your normal review.

Senator LEVIN. So that not only does the appearance of competition hide the kickbacks and the schemes—well, first of all, the appearance of competition, that paper trail of competition does hide in many cases the kickback. That is point one.

There is something else that it does, and I want to get to Ms. Toensing when she testifies on this, because as I understand the current anti-kickback statute, where there is competition—perhaps that means an appearance of competition—we don't have the application of the statute.

But I want to highlight that part of the testimony now because I want to come back to it later.

The appearance of competition does a couple of things. No. 1, it hides the kickbacks. No. 2, it may make it more difficult to proceed under our anti-kickback statute when we finally understand that it was an appearance of competition and not real competition.

Ms. Toensing has been waiting very patiently. She is in the critical position in the Justice Department. They have been so extremely helpful to us that we want to get to them as quickly as we can, and I will just limit my questions, therefore, to one more question of Mr. Sheehan.

I think you were the one who said that there were 10 people who were convicted as a result of the particular investigation you described.

What law were they convicted under?

Mr. SHEEHAN. They were charged with a number of different crimes. For the most part, everyone was convicted of at least one count of mail fraud.

We had others that were convicted in aiding in the submission of a false statement to the Government, and we had a couple of individuals that were convicted under the kickback statute.

Senator LEVIN. For the most part then we did not use the kickback statute?

Mr. SHEEHAN. For the most part, that is correct, yes, sir.

Senator LEVIN. Thank you, Mr. Chairman.

Senator COHEN. Senator Rudman.

Senator RUDMAN. I will be very brief, Mr. Chairman. I just want to talk to Mr. Jamar for a moment.

These statutes we are talking about obviously, although I believe the greatest way to stop this is administratively within the companies, nevertheless we want to make examples of these people.

Under our forfeiture [repo] statutes, of course, we have confiscation of all sorts available to us. Mr. Volz testified that in the case of Louisiana the company made restitution.

I assume that the people involved might have made restitution, also, in some of these cases, is that correct?

I will ask both of you.

Mr. VOLZ. All of them.

Senator RUDMAN. In the full amount?

Mr. VOLZ. Yes, sir, as a result of the sentence and two of them before sentencing, before they were actually—after they pled guilty. So there was 100 percent restitution made.

Senator RUDMAN. I guess my question is: Under the present statutes which you have available, which of course would not be the

forfeiture statute except under a rare circumstance, do you have confiscation available to you under your present statutes?

Mr. JAMAR. I think the kickback statute allows for the amount of the kickback. I think for the analysis of that statute I had better defer to the Department of Justice, but as far as forfeiture similar to narcotics laws, they don't exist in relation to this type of crime.

Senator RUDMAN. I would just say to my colleagues who are the principal authors of this legislation, which I certainly intend to cosponsor, that, you know, we have some strange anomalies in the U.S. laws, civil, and criminal.

We have treble damages under the Sherman Act for price fixing, which is serious. I certainly think that is probably right. But here we have cases where not only are we costing the taxpayers who knows how much money, but as Senator Levin and Senator Cohen and I have commented on this morning, we may be doing something far worse in terms of affecting our national security, in terms of the kinds of weapons systems that we give to our troops.

So I think I would just ask you this question: What would you think of a statutory scheme that raised the stakes for those that were caught, that in fact not only had confiscation but maybe more than confiscation, a la the Sherman Act?

Mr. JAMAR. As I said earlier, we know we can't eradicate this problem. What we want to do is increase the risk. If they know that, No. 1, the money that they get they can't keep, if they know the risk of jail time is increased, if they know that their conduct can be more easily detected and the ability to prove what they have done, prove the scheme, is increased, then all that will result in an increase in the risk and make them think about it.

That is the best we can hope for.

Senator RUDMAN. And a penalty of three to five times that which was actually taken in kickbacks, which means the person could lose his home, his pension, or whatever else he had, that starts to raise the stakes.

I mean, I would vote for that kind of law because I think this is the worst kind of crime because it affects our security.

Senator COHEN. Senator, would you yield for a question?

When you raise the issue of restitution, one of the items, as I recall—Mr. Volz, correct me on this—but as I recall, one of the individuals was being investigated by the Internal Revenue Service for taxes not paid on substantial amounts of money, and all that was done was that the kickback was increased to cover whatever restitution he would have had to make to the IRS.

Is that true?

Mr. VOLZ. I am not aware of that, Senator.

Senator COHEN. It is my understanding that precisely because he was afraid he would have to go back and make restitution under the Internal Revenue Service investigation he simply increased the price of doing business and the kickbacks were increased.

Senator RUDMAN. I have no other questions. I think we will want to work very closely, Mr. Chairman and Senator Levin, with the Department of Justice and those who are involved in this. There could well be a statutory scheme that is not only an improvement on what we have, but there could be some emendation of the statutes that would have truly a chilling effect on those who want to

take these risks because, as these witnesses have testified and I know of my own personal experience, these are the most difficult cases to break. If everybody stays friendly and is very careful, they are very difficult to break.

You have got 10 convictions. I commend you for that. The U.S. attorney says it could be as high as 10 to 50 percent. So obviously we have got the tip of the iceberg. It is not the fault of the Department of Justice. It is just the nature of the crime.

Thank you.

Senator COHEN. Thank you, Senator Rudman.

Ms. Toensing, you are on.

Ms. Toensing has had considerable experience, certainly with Capitol Hill, having served on the Senate Select Committee on Intelligence and now in the Justice Department.

We are happy to have you here this morning, Ms. Toensing, and look forward to your testimony. I know you have a brief statement you would like to read.

TESTIMONY OF VICTORIA TOENSING, DEPUTY ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION, DEPARTMENT OF JUSTICE

Ms. TOENSING. Yes, Senator. Thank you very much.

I am sorry, I was just back getting a little more information. You said something that made a brain cell open up.

I want to thank you for asking us to discuss the Anti-Kickback Act. I have a complete statement for the record,[1] but I will truncate it so you can get to any questions.

Basically, the Anti-Kickback Act prohibits any subcontractor from making a payment or a gift to a prime contractor or to a higher tier contractor or subcontractor. I call it an up-ladder contractor, an easier way to refer to it.

Such payment is prohibited as an inducement only for awarding a subcontract under any kind of negotiated contract. That is the bookend. It is a very carefully carved out, limited prohibition.

When you look at the statute, there are two types of sanctions, the civil recovery of only the cost of the kickback and a criminal fine or imprisonment. The history goes back to World War II, when it was found that fixed cost contracts were really affecting taxpayers because payment of a kickback would mean it had to be paid by the American taxpayer.

Let me go through the elements of the statute. There are three:

First, that the parties are within the class carved out by the statute; in other words, that up-the-ladder kind of a situation.

Second, that there was a negotiated contract.

And third, that there is an acceptance of a payment, directly or indirectly, on behalf of the subcontractor "with knowledge of its purpose to induce the award of the subcontractor or to acknowledge a subcontract or order previously awarded."

In other words, there is a very high specific intent element that gives prosecutors fits when they have to prove it beyond a reasonable doubt in court.

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[1] Ms. Toensing's prepared statement is on p. 81.

The criminal provisions, as we pointed out earlier today, have not been widely used. We usually go to other kinds of statutes, which is like trying to fit the stepsister's foot into Cinderella's shoe in order to get some kind of criminal activity to charge. Sometimes, though, we don't have another kind of statute to use in certain situations. So that is why I welcome these hearings.

Let me point out some of the main problems and how we would like to see them cured.

The first and foremost limitation is the act's requirement that payment of the kickback be accepted with—and I quoted it earlier, so I won't repeat it again—that very specific knowledge and intent.

This limitation precludes the prosecution under the act of kickbacks paid by a subcontractor up the ladder if they are not related to just the awarding of the subcontract.

So this precludes prosecution of a subcontractor who pays a kickback to obtain certain information. It would preclude prosecution in a situation where it is paid to obtain acceptance of items that have not been tested or of items that do not meet certain specifications. There are other kinds of activities that go on in subcontracting that money is being paid for; these aren't covered at all.

Senator COHEN. Would it be covered if one subcontractor paid a 5-percent or 10-percent fee to the purchasing agent to disclose the other bids?

Ms. TOENSING. No.

What we would like to see is to have an expansion, of course, of the prohibitions under the statutes.

I have been in my ex-home State and your home State, Senator Levin, for the past few days. This morning I saw an outline of your proposal, but I don't have the specific wording. I would like to say that I have staff who would be delighted to work with you so that you could get from the prosecutor's standpoint the nuances that we would need for this legislation to be helpful.

The second problem is the negotiated contract, having it limited only to negotiated contracts. That really is a problem for us.

First of all, it is not always clear what a negotiated contract is. We have hybrids sometimes.

Senator RUDMAN. Do you know the history of that statute, Ms. Toensing, as to why that unusual provision was put in?

You may not know. Do you know the history?

I think I would look up the legislative history because that is a very strange provision.

Senator LEVIN. The assumption is if there is competition it takes care of it, right?

Basically, if there were competition at the prime contract level—I described this before—competition at the prime contract level, it is assumed that that would cure this problem, but it surely doesn't. Apparently, it is a way of life.

Senator RUDMAN. It is a very naive assumption.

Senator LEVIN. It sure is. It is a way of life for at least the employees of primes relative to subs.

Ms. TOENSING. And it certainly doesn't apply if there is a sealed bid. So what they do is they sit around the table and say, OK, you go to the low price and I will give you the subcontract and we will split some of the difference.

I would like to point one thing out that I saw this morning in your draft and reacted to. It appears that you are proposing to change the conclusive presumption in the civil cases.

Right now in the statute there is a conclusive presumption that a kickback was included in the price of a contract. You are, I understand, proposing to change that, and that will bring our civil people great difficulty because it would be very difficult to prove, as you have heard here. It is very hard to find it in the books. You will almost negate civil recovery if you change that.

Senator LEVIN. We will work with them on that issue.

Ms. TOENSING. Please.

Thank you very much.

Let me go to the third area, and that is that the act does not prohibit the offer or solicitation of kickbacks. So unless we have a completed act, this act does not cover it. What we would like is have a criminal offense when the payment has not yet been made.

I believe that in the outline of the proposed statute, you do have the attempt there. I think that would cover the situation. As I said earlier, it does not apply to bid rigging. We would ask that that be changed.

Fifth, the penalty structure. We only asked for 5 years; You proposed 10 years. We certainly do not oppose that. I welcome the 10 years.

Let me say something about the treble damages, because my immediate reaction when I read the first draft of this testimony last week was, "Why not treble?" The civil people tell me that there is a problem sometimes in going to court on treble damages in a civil case. When judges see treble damages, they instinctively raise the standard of proof. So there is some caution on the part of our civil attorneys to putting in treble damages, because the courts begin to treat it almost like a criminal case.

So that should be carefully worked out. If we are at all reluctant on treble damages, it is not because we have any favor for these people, but we want to win our cases, and we don't want the courts to require higher proofs in civil cases.

We do ask that you expand this beyond just the defense procurement area. There are other Government contracting situations, for example, in HUD and FEMA and various other places that we think that this whole statute, this whole area could be applicable to. So we've also asked you to look at that. And we would also request that you take a look once more at Senate bill 1675, which we introduced in our fraud package several months ago, because that would not only negate contracts but allow us to recover any money that we have paid on contracts where there are kickbacks under the rationale that these were really void from the beginning.

I would be glad to answer any questions that you have.

Senator COHEN. Senator Rudman has a time constraint, so I will let him go first.

Senator RUDMAN. Thank you, Mr. Chairman. I would just say to Ms. Toensing that I will probably have some questions for you, not necessarily for the record, but I just may send them over to you on a couple of these issues.

I just want to say to the panel that we have a lot of panels over here, but this one is a very good one, starting with Mr. Bonner

from California earlier and the entire panel were very helpful in giving us very direct testimony. I think we perceive the problem.

Now we are going to find out what we can do to help.

So I just want to thank the panel very much.

Senator COHEN. Senator Levin.

Senator LEVIN. Again, let me thank you, Ms. Toensing, for your testimony and your patience. Indeed, your position on this panel, where you came in the testimony, was a product of the logic of the hearing. Your position at the Justice Department is a critical one. You have been very, very helpful in the preparation for these hearings, and we are grateful for it. We look forward to working with you, as we put together a bill which will put some teeth into the antikickback statute.

We recently passed, under Senator Cohen's leadership, the Competition in Contracting Act, and I wonder, when we define competition as including negotiated competition, as well as sealed bid competition, we had a particular effect on the antikickback statute.

Is the negotiated competition in the Competition in Contracting Act considered in negotiations, a "negotiated contract" or competitive contract?

Ms. TOENSING. Right off the top of my head, I can't answer that, but I will get back to you.

Senator LEVIN. I know when Senator Cohen and I cosponsored that bill to try to promote competition in contracting, we surely would not have wanted to have any negative impact on the application of the antikickback statute. Our only intention was to strengthen that impact. We want to make sure that was, in fact, our achievement as well as our intent.

One of the things which we are looking at is a requirement on prime contractors that they notify the Defense Department of suspicions that they have relative to employees soliciting or taking kickbacks. This would hopefully overcome the reluctance that prime contractors have shown to disclose that suspicion, and it is only a suspicion, to anybody. The inclination is to get the person out of the door. When that suspicion exists, let the person resign or ease the person out.

Frequently, the testimony has shown, people end up in the employment of other prime contractors. So we've got to find a way to kind of prod prime contractors and maybe make it possible for them, legally, in terms of their own liability, to inform us or the appropriate agency—either the DOD or some other agency—of suspicions, so that we can prosecute, if the investigation shows those suspicions are warranted, and that we can make sure that the persons who are guilty, don't end up in other employment and that they are also prosecuted.

Do you have any comment today, or would you rather withhold your comment on that aspect of the bill which we are drafting?

Ms. TOENSING. Well, I think it is a very favorable route to go. I would wonder what the sanction would be if the contractor doesn't do it.

Senator LEVIN. It would be a contract violation in that instance.

Ms. TOENSING. This is not a problem just in this area. I have other subject matter under my jurisdiction, like assaults on children, and we have the same problem there. It is a tension between

the rights of our Constitution, the protection of a person's privacy, and the concern for finding criminal behavior and wanting to warn others. We should be looking at that issue across the board, because we have this problem with crimes against children too.

Senator LEVIN. Another aspect of the legislation which we are drafting, at least we are considering, is to make prime contractors civilly liable for their employees' acts, unless they have good faith controls in place to detect the kickbacks and unless they turned over all information and all suspicions that they have relative to the employee taking or soliciting kickbacks to the appropriate agency of the Government in a prompt manner.

It is obviously a complex provision. You don't want to be unfair to the primes who, after all, are not, at least at the upper management level, from what we can tell, usually the guilty parties. It is their employees who are the guilty parties at a lower level, usually. I don't want to be too stereotypical here, but usually the problem is at a lower level in the purchasing department, perhaps the supervising level of the purchasing department.

Do you have any comment at this point on that kind of a provision, which would provide for civil liability for prime contractors, if they don't have, again, a good faith effort in place to detect and deter this type of activity on the part of their employees, and if they don't notify us promptly of their suspicions, at least where those suspicions result in an employee leaving the employ of the prime?

Ms. TOENSING. I would like to look at any provision carefully, but my instinct is that also is a very good route to go. I would like to see that provisions in one or two areas, so that we could experiment with it, and use that experiment for other areas of Government contracts.

Senator LEVIN. Another provision would require an annual sworn declaration by the key purchasing employees with the prime contractors, listing any gratuities, payments that they have received from subcontractors during the prior year. And I might quickly add, if we do this, with the first such sworn statement that we would require, hopefully, it would make them go back in three years or whatever the statute of limitations happens to be.

Do you have any reaction to that particular provision?

Ms. TOENSING. We all do one of those every year. You are required to do that; I am required to do that. I don't have any problems with that.

Senator LEVIN. Thank you for your ongoing help.

Senator COHEN. Just one point I think you raised in your written testimony, Mr. Jamar, You talked about the possibility of engineering and design work filtering up to that level, where someone could take a product and prescribe certain specifications, so it would be limited to a specific contractor. I think, Mr. Volz, you have seen that too. Is it possible that engineers, for example, could be unwitting victims of higher echelon decisions to try and direct a contract to a specific contractor by saying these are the specifications we want? Or are they part of the problem, as well?

Mr. JAMAR. I think there is a possibility that they could be unwilling victims from the other direction too. The buyer could say, "You have to change this" to fit something he knows exists. So it

works both ways. I think the cases in which engineers have been directly involved are rare, but the possibility is there.

Senator COHEN. I want to thank each of the panel members for coming this morning. It was very helpful to us in building a record, and hopefully, for proposing changes to the antikickback statute.

Thank you very much.

As was indicated earlier, Mr. Smith, the subcontractor from California, who was scheduled to testify before the subcommittee this morning with his identity concealed, decided late yesterday afternoon, as late as last evening, that he would not testify, because the risk was simply too great for him. And as Senator Rudman pointed out, the fact that he refused to come to Washington provides evidence to the subcommittee of the pervasiveness of kickbacks in the defense industry and of the risks to an honest person who refused to play the game.

Mr. Smith, had he testified, would have related his firsthand experience of what happened when a subcontractor refuses to play the game. A couple of years ago, he complained to a manager of a major defense firm about a buyer whom he suspected of revealing Mr. Smith's bids to his competitors. One has to ask, what was the result of that individual complaining to this major company about the fact that his bids were being revealed to his competitors? The answer is, no action was taken against the buyer, no investigation was launched. The result was that the company blackballed Mr. Smith's firm. Prior to complaining to the firm's senior manager, Mr. Smith's company did some $200,000 worth of business with that prime contractor. Two years after complaining about it, he received no subcontract business with the corporation.

So even though we were making every effort to conceal his identity, he nonethless believed that testifying before this committee, even under the exclusionary circumstances, might have been the "kiss of death" to his firm.

Later on, after we have our next witness, I will ask the subcommittee's attorney-investigator, Elise Bean, to testify about her interviews with Mr. Smith, so at least his experiences can become part of the record.

But in the meantime, because he's been very patient, I now call Mr. Tom Carvey, the vice president of Hughes Aircraft Co. He is going to testify on the efforts of his firm to insure ethical buying, after several Hughes employees were indicted for taking kickbacks.

Mr. Carvey.

TESTIMONY OF TOM B. CARVEY, JR., CORPORATE VICE PRESIDENT, HUGHES AIRCRAFT CO.

Mr. CARVEY. Thank you very much, Mr. Chairman.

I appreciate the opportunity to be here. We have submitted a statement[1] and would propose that that be incorporated in its entirety. In the interest of time, I will simply summarize and hit some of the highlights.

Senator COHEN. That would be acceptable, Mr. Carvey. Your statement will become part of the record.

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[1] Mr. Carvey's prepared statement and responses to written questions from Senators Cohen and Levin are on p. 89 and p. 102.

Mr. CARVEY. Very good. Thank you.

I want, first of all, to emphasize the fact that at Hughes—and I think this is characteristic of the defense industry—subcontracting is a crucial enterprise. It is very important to us. In our case, we are subcontracting, perhaps, in excess of 40 percent of our sales in the aggregate. Not necessarily the kind of subcontracting you've been talking about today, but in the aggregate. So it is very big, it is very important to us and our suppliers are very important to us.

And I have to say this, that the integrity of this operation is also extremely important, because we cannot operate without a condition of mutual trust with these suppliers on whom we are so heavily dependent. Clearly, without that, we are not going to succeed. We are not going to be able to provide what the Government has the right to expect from our efforts.

You have addressed to us several questions which we tried to respond to. The first question has to do with the kickback issue and how it was discovered in our case.

In our case, it came about first by seeing certain irregularities in our procurement process by audit, if you will. But the key element really ended up being an allegation by a supplier who came to us at a procurement conference where we were working and talking to a group of suppliers. He mentioned that evening that he had this problem, and didn't want to pay kickbacks any more. He said that to one of our managers, and I think we had him in the office at 8 o'clock the next morning to explore that further.

We immediately got our own internal security on the job, and we did corroborate some of the facts about the situation. We certainly uncovered nothing to refute the allegation. Therefore, we immediately went to the FBI to report the incident and to get their assistance in investigating it.

We believe that it was our detection of this particular lead that initiated the FBI's successful investigation that you have heard about today in these hearings. We think we were the leading edge of that. The FBI, of course, used undercover tactics, as have been described. I also believe that the FBI really deserves very high commendation for their efforts in cracking the case. We consider this as very serious to us in the company. We see that it requires firm and vigorous action. It is really a matter of fundamental importance that goes all the way to the top of the company. So we have worked at detection and prevention very, very energetically.

At Hughes, the problem seems to have centered on the suppliers who supplied outside services, like machine shops. These are the so-called hard-to-price elements of our subcontracting.

It's a highly competitive business. And, for several years, very few of these shops have really been operating at their full capacity. So while there may be a popular perception that increased Defense budgets have created a highly prosperous environment, in fact these shops are engaged in a dog-eat-dog competition.

This then is the environment of the kickback activity. It's hard to know exactly how much a job should cost. Among experts there can be valid differences of what costs you're talking about and there can be valid differences of over 10 percent on what a job should cost.

We therefore have a situation where buyers, who are demanding kickbacks in the 10 percent region, were operating in an area where detection was hard.

And, further, suppliers who were seeking a dishonest advantage might find such markups rather easy to conceal. So those are the circumstances. There are some other areas of vulnerability I might point out that we're addressing, and I think others in the industry are addressing, where there are hard-to-price items, like in the construction business, and in rearrangement work on buildings and such things. Some of our graphic arts services and sophisticated reproduction work also could be vulnerable.

Now I would like to emphasize that we have no evidence or even indication of kickbacks or fraud in the other major areas of our procurement business, in the case at Hughes.

For example, in our major subcontracting, electronic parts procurement, computers and software, complex components, et cetera we have not had allegations of this kind.

Senator COHEN. How would you know?

Mr. CARVEY. Of course, you don't know. I guess it's like trying to prove virginity—trying to prove that something has not happened—In this case, you don't really know until you discover an event. But, in these cases, we have not had allegations. We have not discovered questionable issues within our general audits.

And we've changed audit patterns and tried to be creative about how we go about it. We don't know it is absent. But, the fact is that we don't believe that it's there.

But I guess I would echo and try to reinforce what Senator Levin has said, that, really, most of our suppliers, we really believe are honest. We've worked with them very closely. We have great confidence in the integrity of the vast majority of them. We really believe that.

Senator COHEN. In spite of what Mr. Bonner said today, that this sort of kickback activity is as high as 50 percent on the frontline?

Mr. CARVEY. Recognize that we're dealing with about 7,000 suppliers overall in any given year. We may be talking about 200–300 in the category that we're addressing today.

And, yes, I think the other factor is of course, today, we're looking at the "exceptions." Deliberately. We're deliberately looking at the bad aspects of what's going on. And we're not here in a position to address the healthy, favorable aspects of what is going on within the industry.

Senator COHEN. How much money was involved in the kickback schemes that led to the prosecution of eight employees?

Mr. CARVEY. It's hard for us to tell. Not all the records were out. None of the cases went to trial and, therefore, all the facts we have are those stated in the indictments.

In the indictments, it merely listed certain specific cases where there may have been $3,000–$4,000 elements, or here a $10,000 element, things of that sort. We really don't know in the aggregate.

Senator COHEN. Were the bids submitted by the subcontractors inflated to cover the kickbacks?

Mr. CARVEY. The one supplier we can identify that assisted the FBI in the investigation told us that, on an annual basis, that he

was paying about 7 percent. He felt that about 7 percent of his gross represented the payments that he had to make.

Senator COHEN. I'm sorry. Why don't you continue with your statement?

Mr. CARVEY. Now, in our case, I want to emphasize this, where these irregularities are detected, we put our own internal security to work immediately. And where there is any indication of fraud, it has long been our practice, and I think will always be, that we go to the FBI. That's just the way we do it. We notify them and we request assistance.

On the subject of bid-rigging, we do not have any direct evidence of it. But we certainly are aware of the courtesy bidding possibilities. We've heard it ourselves. We've searched for it and are seeking it.

Senator COHEN. My understanding is that Hughes has conducted a survey among your suppliers and that you found something like 41 of 197 suppliers who were interviewed who had some degree of knowledge about kickback activities?

Mr. CARVEY. That's right. We sent out our procurement men, a dozen senior level managers, to make contact with those suppliers.

First of all, we wanted them to understand our ethics. And we wanted them to behave the same way. Clearly, we were asking them directly: Has any Hughes employee ever approached you for kickbacks in any way? Anything like that?

And, further, we were listening to anything else they might tell us. Now, 41 of them did indeed say they had some degree of knowledge that this was going on. None volunteered that they were doing it. But, at least they said, yes, this is going on in the industry, and gave us some leads which we could pursue and pass on, incidentally.

Senator COHEN. Did you pass that information to the FBI?

Mr. CARVEY. Yes. Any information we got of this sort was passed on.

Senator COHEN. Could the committee have a copy of that survey?

Mr. CARVEY. I see no reason why not. Let me undertake to do that for you. I think one thing that is disturbing though is that only one supplier to date really has been identified. And, clearly, there's little doubt that there must be others. The investigation by the Federal authorities has yet to produce indictments or to make public any of the information about other suppliers.

That's a disturbing thing to us, since we probably are still doing business with some, and I would just like to emphasize that.

Now, in our policy, our procurement policies are very comprehensive. They have many checks and balances in them, in the DOD business in particular. DOD procurement subcontracting really goes beyond the accepted commercial practice, especially in the area of documentation. We really do do a lot of writeup to provide a trail to examine and show us what's going on.

Maybe that's working against us and it offers a way of concealing things. But, at least, we do do that. I would like to submit for the record a package of materials that we have sent, both to our own employees and also out to the suppliers, as a way of increasing awareness and calling attention to what we're talking about today. We have found within our own company, and I think we find it

elsewhere in the industry sometimes, that people who have not had contact with criminal activity find it difficult to believe or accept that their own employees or colleagues are in fact stealing or accepting bribes; that there's a sense of disbelief, even when they're confronted with the fact of kickbacks in a sister organization.

So the issue of working for awareness is a very important one.

Internal security is very important in a company such as ours, and we have always maintained what we consider to be a first-class operation. Ours is now run by Ed Best, who does that after some 22 years with the FBI, including 3 years as special agent in charge of the Los Angeles Office, from 1980–82. I think that's also crucially important for us.

We have tightened our internal procedures over the last several years, when we first began to suspect and became aware of this. To a considerable degree, we have acted to increase surveillance, changed our audit patterns, tightened controls. We've rotated personnel. We've changed organizations. And we've reduced the number and increased discipline at order release points.

So there's been a lot of vigorous activity in that regard. I've already mentioned the fact that we've been out to our suppliers, and we have initiated as a followup a supplier self-certification program in which each supplier performing this kind of work is now required to sign a certification that says he understands all the liabilities of violating the laws—the whole thing—and he's not doing it—as a further way of reinforcing our intent.

We have had a very strong educational program both within Hughes and out in the industry. We've put out this little booklet on "Ethics in Buying, a Matter of Integrity," which has become a bit of an industry best-seller. We've put about 80,000 of them in the hands of our suppliers and employees, to show them that we really mean it; because some of these are not just criminal violations. We're talking about ethical violations as well.

And we try to deal with that. We have gone from that to a training tape. We have it in film and tape, based on the booklet and featuring not only the president of the Hughes Aircraft Co., Don White, but also, for example, Mr. Sheehan, from the FBI, to try to drive home the importance of this issue.

And, again, I would submit a copy of this to the committee for the record and for your potential interest.[1]

Finally, because gifts and gratuities can become an introduction to unethical and illegal practices, we strongly address this in all these materials, and we have to sustain it. We try to have programs such as one this past Christmas, where we put out a little greeting card, instead of just the normal, almost perfunctory letter, which most primes might send out to suppliers, saying:

Hey, don't send people anything at Christmas. It's against our policy.

We put out the little greeting card this year, which I think had a little more shock effect, just to remind people that it's not to be done. And Hughes employees are instructed not to accept anything, and return anything if they receive it.

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[1] See p. 118.

So it's again an illustration of followup and persistence and a sustaining activity.

Now, the issue of employment checks, the revolving door or musical chairs of buyers who leave the company, is a very disturbing and insiduous situation. It's already been brought out in prior testimony that, frequently, a buyer, when confronted with something—and it's not always an accusation as such—that the buyer at that point may merely resign and then subsequently go out and take a job at another company.

And this is tough. It's tough to know exactly how to handle this. If you merely act on the basis of suspicion, clearly, you're opening yourself to risk of defamation or invasion of privacy, things of that sort.

[Subsequent to the hearing Mr. Carvey submitted the following information:]

Please understand that when an allegation against one of our employees is received, we feel an equal obligation to clear the name of an employee wrongly accused as we do to identify, discipline, and prosecute one who is guilty. False accusations are not rare. For one thing, in such a highly competitive market, a losing salesman may be tempted to excuse a lost bid by telling his boss that the buyer may be accepting kickbacks from the winning bidder. That scenario, and many others, can produce false charges that could damage the reputation and career of an innocent person.

Mr. CARVEY. Sometimes, you really don't know anything. We have made a suggestion here—and it's only a suggestion—it certainly does not represent a recommended piece of legislation as it is suggested. We observe that the Fair Credit Reporting Act that was enacted by Congress in 1970 balances the need for the credit business community to collect and disseminate credit information necessary for sound business decisions, while extending the right to the consumer that the information be relevant and fair. In other words, the individual has some protection. The act furnishes to those complying in good faith with its requirements some measure of protection from claims of defamation and negligence for the content of credit reports.

In other words, we're thinking that something like this may be possible, at least within the defense industry, where I think there is perhaps a stronger stake than what exists strictly in the commercial community, even though that commercial community is not immune, obviously.

I'd be happy to entertain questions.

Senator COHEN. Mr. Carvey, thank you very much for your testimony. Just looking at the greeting card that you sent out, I commend Hughes for adopting that policy. My understanding is that Avondale, which was mentioned several times here this morning, is also undertaking similar kinds of practices and policies to prevent the kind of corruption that has taken place in the past.

I indicated before that, following your testimony, the Chair was going to call upon Elise Bean to provide a summary of the information that Mr. Smith would have stated had he testified this morning.

We have decided that we're going to make another effort to see if we can't persuade Mr. Smith about the invaluable contribution his testimony would make, and undertake even further security meas-

ures to protect his identity. We feel it's so important that we're going to make a second effort.

Senator Levin, why don't you conclude the meeting with Mr. Carvey?

Senator LEVIN [presiding]. Thank you, Mr. Chairman.

Perhaps, before you leave, if we're unable to achieve that goal of getting him on another occasion to testify, then we could put into the record Ms. Bean's summary of the conversation, if that would be all right.

Thank you.

Mr. Carvey, first let me thank you and your company for your efforts and your testimony.

It is very important that people realize that there are companies such as yours that are willing to do what you have done. It is important that other companies do what you have done and we make it easier for employers to act on their suspicions in a way which does not unfairly deal with employees who might be innocent.

We obviously want to protect innocent employees, but we are going to get to this cancer. It is one. Everybody knows it. We haven't gotten to it for many reasons, one of which is employer reluctance, fear of liability if they might be wrong.

Another one is that we have a toothless, to some extent at least—weak, I won't say toothless—a weak law. The laws on the books just don't do the job for us. We are going to offer some amendments in that regard.

In the meantime, we are grateful to you for your actions to try to stamp out the very rampant practice which we have of kickbacks paid by subcontractors to certain employees of prime contractors.

Now, you have gone into a possible legislative remedy. I want to focus on that. Page 10 of your testimony. You have talked about the Fair Credit Reporting Act and using that as a possible analogy, and what you said is that that act furnishes to those complying in good faith with its requirements some measure of protection from claims of defamation, invasion of privacy, and negligence of the content of credit reports.

The provision that I have discussed here and described earlier this morning in our bill which we will be introducing relates to that, to give some measure of protection against that reluctance.

Is that the reluctance, you think, which has caused so many employers to try to push the problem out the door instead of turning it over to the proper governmental agencies?

Mr. CARVEY. It is hard for me to answer that. In our case we are so strongly committed to going to the Government agencies, and I think that is true for others in such cases. But look at our case.

We went directly to the Government. We were apparently the first people to turn this up. We provided the lead that allowed this case to eventually be broken. Of course, it is expanding now beyond the early limits.

But in our case what has happened as a result of all that and all the diligent work over 2 years is that when the case breaks, 8 out of 10 employees indicted are from the Hughes Aircraft Co., and in a way, the defense industry is indicted.

Now, the media almost always seems to confuse the victim with the perpetrator in cases like this, and indeed when this comes out

repeatedly in the press and there are the pleas entered and the convictions and the sentencing, it always comes out that it is Hughes Aircraft buyers who have been on the take, and that isn't good publicity for us.

We are willing to pay that price. It is worth the price to be able to identify this and clean it out. I think that we must, however, get this across:

It might be helpful if public officials and others could distinguish between the victim and the perpetrator. I think that would be helpful.

There would be an incentive to industry, I think, if they thought: we are going to take this case in there, knowing we are being victimized, and it will be presented in a fashion like that—with clear distinction between victim and perpetrator.

Senator LEVIN. That is a suggestion which I think all of us ought to give consideration to. Any suggestions that you might have as to how we can do that would be welcome because we are going to get at this evil.

And there is a problem obviously that can be created unwittingly for employees who are cooperative; that is, that he is identified as an employee of company X. That is publicity that company X doesn't want. That company X might be willing to come forward, and indeed in your case offered the lead, but it still winds up connected in the headline with the perpetrator.

I don't know any easy answer to that, but I know that that cannot stop us from doing what we have to do. Any suggestions as to how we can minimize the damage that the victim is paying or undergoing will be more than welcome.

I take it then that negative publicity is one of the reasons why so many companies are reluctant and point to that as your first reason.

Is that fair to say?

Mr. CARVEY. Yes, I think that the colleagues that I associate with in industry want really—when thinking it through—to say: "I want to be there first, I want to discover the case, I want to take it to the FBI," and they are motivated to do it.

Perhaps even the attention of this hearing is going to bring about a greater degree of awareness. Even though I and others have been out speaking to industry associations and other groups to bring this point forth, I think this is a more powerful forum by which to do that.

Senator LEVIN. One of the provisions of the bill that I am introducing, with Senator Cohen's cosponsorship—and Senator Rudman indicated this morning and Senator Chiles indeed indicated an interest, also, in this that is very much welcome and needed, so that the bill has that kind of broad cosponsorship—but one of the provisions relates to a requirement that employees who are on the frontline, who are engaged in purchasing for prime contractors, file sworn affidavits as to what they have received. We will have to identify that group of employees to make it a class which is manageable, to hit the right people.

Does that create any problem for you?

Mr. CARVEY. It does not create a problem. It is only a short extension beyond what we already require. We don't require sworn

statements, but we do require certification by every employee every year regarding ethical conduct.

Senator LEVIN. I don't know how many employers do that. I doubt that very many of them even go as far as you do to make that the requirement of a contract.

I think what we will do here, because of the hour, is ask that you answer any additional questions that I might have or my colleagues might have, that you answer those questions for the record if you are willing to do that.

Mr. CARVEY. I would be glad to.

Senator LEVIN. I guess I have one other question quickly, and that is—people who were accused in your situation, what kind of record did they have? Did they have good records as employees prior to this information coming forward?

Mr. CARVEY. I would have to say they had satisfactory records, yes. There was nothing in the record to suggest that we were bringing in a problem when they came on board. In fact, maybe they didn't have a problem when they came on board. Maybe it developed by their association with other persons out there, but I don't think the records showed that there was difficulty.

Senator LEVIN. The additional questions that I have I will ask that you answer for the record.[1]

We will adjourn this hearing at this point. Senator Cohen has indicated we will attempt—make one other additional attempt at additional protections for "Mr. Smith" to get him in here.

We thank you for coming forward and for your patience, and we will now adjourn this hearing.

[Whereupon, at 12:15 p.m., the committee was adjourned subject to the call of the Chair.]

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[1] See p. 102.

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF ROBERT C. BONNER

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

My testimony today is aimed at providing the members of the Subcommittee with an overview of the problem of kickbacks on government subcontracts in the southern California defense industry. My comments will be directed to three areas: (1) the scope of the problem; (2) the components of typical kickback schemes; and (3) the difficulties in detecting and prosecuting kickback cases.

THE SCOPE OF KICKBACK FRAUD ON DEFENSE CONTRACTS:

At the outset, I define kickbacks broadly to include anything of value that is given by a subcontractor to an employee of a prime contractor or higher tier subcontractor either to influence the employee's decision as to whom subcontracts will be awarded in the future or as a consideration for subcontracts which have already been issued.

During the past 18 months, approximately 15 individuals have been prosecuted successfully by my office for giving or receiving kickbacks in connection with defense subcontracts. Those cases included convictions of eight purchasing officers of Hughes Aircraft Company, and at least one such employee from Northrop Corporation, Hughes Helicopter Company, Raytheon and Teledyne. Several defendants held managerial positions in which they

supervised other buyers. The procurement programs involved in those cases included the Air Force's Stealth Bomber, the Navy's A-6 Aircraft, the Army's M-1 and M-60 tanks, and laser targeting systems for the marine corps and other services. The violations charged occurred continuously over the period 1981-1985.

Based on an analysis of the evidence in the foregoing cases--which included over 100 hours of undercover tape-recorded conversations with buyers at three major prime contractors -- as well as information which is not a matter of public record, it is painfully clear that the cases which we have filed to date are merely the tip of the iceberg.

It is my opinion that kickbacks on defense subcontracts are a pervasive, longstanding practice which has corrupted the subcontracting process at most, if not all, defense contractors, and infected most, if not all, defense procurement programs within the Central District of California. While it is extremely difficult to make a precise estimate of the percentage of defense subcontracts which involve kickbacks, reliable and informed individuals who have been cooperating with the government's investigation of the problem estimate that up to fifty (50) percent of the buyers or front line procurement personnel at prime

contractors take kickbacks in return for issuing subcontracts.

Whatever the precise percentage is, however, it is beyond doubt that kickback schemes are one of the most serious types of defense fraud. It is a practice which one judge in our district characterized in a recent sentencing proceeding as being akin to treason. Kickbacks destroy competition in the marketplace for defense subcontracts; inflate the prices the government must pay for defense procurement, and jeopardize the quality and reliability of the defense industry's goods and services upon which we all depend for our national security. Kickbacks reward those who are willing to pay bribes over those honest suppliers who strive to succeed by offering the highest quality products at the lowest possible price. The pervasive and entrenched practice of kickbacks has reached such dominating proportions in the subcontracting process that, sadly, many suppliers believe that they cannot survive economically unless they pay kickbacks. On the buyer's side, many see the practice as so widespread and longstanding that they rationalize: "If everybody else is doing it, why shouldn't I?"

In sum, the kickback cases which we have prosecuted thus far are not reflective of isolated corruption of recent vintage; rather, they are merely exemplars of widespread fraud throughout the defense industry.

THE NATURE OF KICKBACK SCHEMES

Kickback arrangements have several components. At the core is an agreement by a subcontractor to pay a percentage of the value of all subcontracts it receives to the buyer who awards those subcontracts. The percentages vary from scheme

to scheme but generally consist of payments of 5% to 10% of the value of every subcontract received by the supplier from the buyer with whom he has conspired.

In addition to taking a percentage of every subcontract, buyers, especially on cost plus contracts, enter into so-called "bump" agreements with suppliers. In a bump arrangement, the buyer tells the supplier the amount by which the supplier can raise his bid and still obtain the contract as low bidder. The difference between the original bid and the elevated bid is then split between the buyer and supplier. In a tape-recorded conversation, which I have supplied to the Subcommittee, between a cooperating supplier and Ronald Brousseau, formerly a manager for procurement on Northrop's Stealth program, Brousseau tells the supplier that he will have to pay Brousseau 5% of the value of each subcontract and 25% of any "bumps."

Payments of kickbacks are generally in cash, with either all or half of a kickback paid upon the issuance of a purchase order, and the remainder, if any, when the supplier is paid by the prime on the subcontract. Kickbacks are sometimes paid other than in cash. For example, a former supervisor at Hughes pled guilty to receiving an all expenses paid European vacation for himself and his wife as a kickback on a government subcontract. Undercover tapes in the case against buyers at Hughes revealed that one defendant had received payment from two suppliers in the form of cocaine. In one of our cases, a vice president of Teledyne took his payments by checks made payable to a shell company he formed to launder his kickbacks. He appropriately called his company "Profit Maker Enterprises." Finally, during our undercover

operation at Hughes, one buyer requested a supplier who was cooperating with the FBI to purchase a second car for him instead of sending him on another European vacation. When the supplier balked, the defendant purchased a Chevrolet Camaro Berlinetta for more that $12,000, told the supplier that he had paid for the car by check, and demanded that the supplier pay him the money for the car in time to cover his check. When the supplier refused, the buyer obtained the money from a competing supplier.

While many kickback schemes involve a single buyer, some buyers work together to share kickbacks and to exert greater control over subcontracts issued by a particular department at a prime contractor. Our cases showed that this was a longstanding practice in one department at Hughes Aircraft Company. Of the eight Hughes' employees charged, five, including a supervisor, were convicted of working together to share kickbacks in the electo-optical and data systems group. The evidence showed that the supervisor who orchestrated the scheme was the third in a series of supervisors who were involved in the scheme.

Another common, and almost necessary element of kickback schemes is the practice of courtesy bidding. Courtesy bidding involves a group of suppliers who act in concert with a corrupt buyer in taking turns being the low bidder on subcontracts. In such situations, one supplier is selected by the buyer to receive a subcontract, and the remaining suppliers submit artificially high bids -- courtesy bids -- to allow the subcontract to be awarded to the "low" bidder at an inflated price which covers the cost of a kickback and any bumps involved. In the cases we have prosecuted thus far, courtesy bidding

has been common. In the Northrop case, the defendant told our cooperating supplier that he had lined up other suppliers to rotate bids. The defendant also proposed a code by which he would indicate to the suppliers when they were to submit a courtesy bid. In the Hughes case, a number of defendants employed courtesy bidding as part of their kickback schemes.

Where courtesy bidding is not employed, buyers often achieve the same result by disclosing legitimate bids to a corrupt supplier and disqualifying legitimate low bids. In the Northrop case, the defendant told the supplier what other suppliers had bid on a subcontract. He then said he would disqualify the low bidder. The supplier and defendant then met at a restaurant to fashion a low bid which would be as close as possible to the next highest bid without appearing suspicious. That meeting took place days after the Northrop deadline for bids on the subcontract had expired. The buyer told the supplier to backdate his bid so that it would appear to have been submitted on time.

In many cases, kickbacks are not a mere gratuity, they are a quid pro quo for the supplier to receive work. Both the supplier who cooperated in the investigation at Hughes and the one who did so at Teledyne had stopped paying kickbacks at those companies prior to their working with the FBI. Both had been cut off from further work by the buyers they had previously paid. When, under the supervision of the FBI, they agreed to resume payments, the buyers involved immediately began to direct work to them.

In other cases, it is the supplier who first offers to pay kickbacks. In yet other cases the buyer and supplier are equal and willing partners in kickback schemes.

Nor are kickbacks of trivial value to the recipients. The defendant at Northrop viewed the Stealth program as a means to retire early on the proceeds of his kickback scheme. The Raytheon executive we convicted admitted to receiving over $250,000 in kickbacks on defense subcontracts. In the Hughes case, the defendants talked freely about a former supervisor who took over $250,000 in one year.

DIFFICULTIES IN DETECTING AND PROSECUTING KICKBACK CASES

Because the paperwork related to subcontracts on which kickbacks are paid appears to be legitimate and does not on its face reflect the payment of a kickback, detecting kickbacks is difficult. Generally, the existence of kickback arrangements and their successful prosecution depends upon the cooperation of an insider to the illegal scheme. Investigation and prosecution by law enforcement is hampered by an industry practice in which prime contractors, upon receiving allegations of kickbacks being paid to an employee, often confront the employee with the allegation, and then demote the employee or transfer him to a job which does not involve awarding subcontracts. In many instances, the employee then resigns, and obtains employment at other prime contractors where he continues his kickback scheme.

PROPOSED REMEDIES

Criminal prosecution alone cannot solve the problem of kickbacks. A coordinated approach which involves the

participation of prosecutors, legislators, the Defense Department and prime contractors is needed.

As for legislation, Deputy Assistant Attorney General Victoria Toensing of the Criminal Division will report the recommendations of the Department of Justice.

Most of all, however, everyone involved in the defense procurement process must be willing to acknowledge that kickbacks are a serious problem in the defense industry and commit themselves to a sustained effort to remedy the problem. If they do, I am confident that we will be able to reduce significantly, if not entirely eliminate, the problem. In any event, my office, jointly with the Federal Bureau of Investigation, the Defense Criminal Investigative Service, and the Internal Revenue Service, will continue vigorously to investigate and prosecute those involved in kickback schemes.

PREPARED STATEMENT OF JOHN VOLZ

Avondale Shipyards, Inc., is one of the largest employers in the New Orleans, Louisiana area, employing over 5000 persons in the New Orleans metropolitan area, and does ship construction and ship repair in both the private and public sector. Avondale is the largest private employer in the state. From 1980 through 1983, Avondale's business has been approximately 30% federal government related and 70% private.

All direct costs on a particular construction or repair job are billed directly to that job. Indirect costs relating to overhead are allocated against the various jobs in the shipyard at year end. Allocation is made by totaling the direct labor hours for the entire shipyard and dividing this figure into the number of direct labor hours used on a particular job. The resulting percentage is applied to indirect costs for allocation to a particular ship. The federal government paid the following percent of overhead cost at Avondale during the years indicated:

YEAR	PERCENTAGE OF OVERHEAD PAID BY THE FEDERAL GOVERNMENT
1979	31.8
1980	28.2
1981	26.3
1982	28.8
1983	27.2

The ongoing two and one-half year investigation of various activities at Avondale has disclosed that kickbacks were a way of life at Avondale, involving both vendors and Avondale employees in key positions to order, purchase, or pay for supplies to be used by Avondale. Through the various schemes differed in their approach, the end results were normally the same, certain Avondale employees received thousands of dollars in kickbacks, and certain vendors received the lion's share of business as well as part of the payments derived from the submission of false invoices, Avondale paid for these kickbacks through payments on false and inflated invoices that were submitted, and ultimately, the federal government, as the result of contracts with Avondale, paid approximately 25% of the monies lost by Avondale through fraud on indirect cost and paid all monies on direct costs to government contracts.

I will give you two examples of schemes that occurred at Avondale to illustrate my point. In the first situation, the head of the Maintenance Department for Avondale, who was charged with ordering parts and equipment, and with receiving, reviewing, and verifying invoices, conspired with three vendors who provided services and supplies to Avondale's Maintenance Department, and with a truck driver employed by Avondale to overbill the company for more than a million dollars during a three year period. With the exclusive control of ordering supplies and reviewing the invoices for correctness, the Maintenance Supervisor would contact each of the vendors, indicate what equipment, parts, or services information should be placed on false invoices of the vendors, and

approved the invoices for payment by Avondale. The truck driver would falsely indicate on a delivery ticket that the parts and equipment invoiced had been d livered. To obtain his kickbacks, the Maintenance supervisor utilized two methods: (1) he would either split the Avondale payments on the false invoices with the vendors, or (2) the vendor would keep the entire Avondale payment on the false invoices, but the Maintenance supervisor would make personal purchases at various stores in the New Orleans area and send the invoices to the vendors for their payment. The vendors in return received almost all of Avondale's business in the maintenance department area and a share of the proceeds from the false invoices. Furthermore, all kickbacks paid to employees were ultimately paid by Avondale through the false invoicing process.

In most instances, either the bid system maintained by Avondale was bypassed or once the bids were submitted, the supervisor simply ignored the results.

The United States paid for a large percentage of these indirect costs atAvondale arising from the false and inflated invoicing for parts and services. As a part of the plea agreements in the case, the vendors and the Avondale employees are paying restitution to Avondale, and in return, Avondale, based on a Defense Contractor Audit Agency review, is reimbursing the federal government for those fraudulent costs that it had to pay pursuant to federal contracts.

A second scheme at Avondale related to the purchasing of welding equipment and welding supplies. Certain welding supplies such as welding rods were direct cost to government contracts. In

essence, certain vendors of welding supplies and equipment received most of the welding supply business from Avondale between 1979 and 1983 as the result of the payment of substantial kickbacks to a senior purchasing agent, a welding warehouse supplyman, and a Welding Department superintendent. These vendors recouped the kickback payments by charging inflated prices to Avondale.

In this particular scheme, the vendors were paying the warehouse supplyman a kickback of 5% of the purchase price of certain welding items, and a specific dollar amount per item on other welding supplies in return for substantial orders from the supplyman. The vendors would also pay a senior purchasing agent a percentage of the purchase price for buying those items recommended by the warehouseman and for purchasing various other items that were under the control of the purchasing agent. The Welding Department superintendent also received cash kickbacks for ordering certain welding machines from a certain vendor and his manufacturer.

The Avondale employees received their kickbacks through monthly cash payments and through the use of credit cards and charging privileges provided by the vendors. In fact, the senior purchasing agent maintained a ledger with a running total on the kickbacks owed by vendors based on purchases made. When the purchasing agent received cash payments or used the credit cards of the vendors, he would credit the vendor ledger for the payment. A copy of the ledger has been furnished.

Over the period of the scheme, the purchasing agent received over $350,000 in kickbacks, the warehouseman received well over $300,000, and the welding superintendent received over $10,000.

The bid procedures in effect at Avondale were again circumvented. For certain welding supplies, the vendors and the warehouseman devised a scheme whereby each vendor sold the same welding item under a "unique tradename." The Avondale warehouseman and buying agent would specify parts under the fabricated tradenames thereby assuring sales to the designated vendor. In other instances, the welding superintendent had department employees "test" various welding supply items and find that only those items sold by the vendors paying the kickbacks were satisfactory for purchase. The superintendent and the purchasing agent would then justify buying these supplies at inflated prices.

Again, as part of the plea agreements in the case, all of the participants have agreed to restitution, and Avondale has reimbursed the government using the total amount of kickbacks to the Avondale employees as the false and inflated figure.

Based on findings from the federal criminal investigation and the Defense Contractor Audit Agency audit conducted in conjunction with the investigation, Avondale suffered a loss of approximately $5,600,000 as a result of kickback schemes and thefts of petty cash through the issuance of false vouchers by Avondale employees. As a result of fraudulent costs charged directly or indirectly to federal government contracts, the United States paid approximately $1,058,021 in overcharges with an interest accrual of approximate-

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ly $439,696 on the overcharges. Avondale has currently repaid $1,496,621 to the federal government.

ISSUES TO BE ADDRESSED

Q1. Whether subcontractor kickbacks are a longstanding, serious, and nationwide problem for the defense industry?

A. In almost every situation where a kickback scheme existed, the defendants stated that their predecessors at Avondale in the same positions participated in similar kickback activities and that the defendants just continued a tradition of kickbacks. The statute of limitations had run on the earlier activities when the investigation commenced. The criminal investigation also has disclosed that some vendors engaged in kickback schemes at Avondale were also selling their supplies to other shipyards elsewhere in the country.

Q2. The different types of subcontractor kickbacks that take place in the defense industry?

A. I have previously indicated two examples of kickback schemes at Avondale resulting in the payment by the federal government of false claims. Other examples are briefly listed below:

a. Welding supply vendor and Accounts Payable supervisor submitted approximately $550,000 in false invoices for

alleged welding supplies sold to Avondale and split the proceeds;

b. Various Avondale personnel falsified vouchers for employee expenses, obtained reimbursement from the petty cash fund, resulting in a fraud on Avondale of over a million dollars;

c. A vice-president of Avondale in charge of purchasing barges and related equipment for Avondale used his own corporation as a middleman to greatly inflate the price of the barges and other equipment sold to Avondale and pocketed the profit;

d. An Avondale warehouseman stole welding parts from the Avondale warehouse, discounted them to a welding supply vendor, and then repurchased the same parts at retail from that vendor;

e. Avondale employees received services and/or supplies from vendors, i.e. furniture, carpeting, repairwork on houses, and caused the vendors to submit false invoices which were charged to particular government jobs for reimbursement;

f. An Avondale vice-president was required by Avondale to make local, state and federal campaign contributions, and then submitted fictitious expense vouchers to Avondale to reimburse himself for the contributions. The falsely claimed expenses were treated as indirect costs to Avondale customers including the federal government.

Q.3 Whether subcontractor kickbacks are typically associated with certain types of subcontracts and, if so, the nature of those subcontracts?

A. Our investigation of the Maintenance Department and the Welding Department centered on those areas where substantial purchases of equipment and supplies from vendors occured. We found that Avondale had few internal auditing procedures to check employees who had control over billings and payments. Each of these departments was rife with kickback schemes.

Q4. Whether subcontractor kickbacks are typically associated with bid-rigging schemes and, if so, the nature of those bid-rigging schemes?

A. Although the vendors participating in the kickback schemes generally charged Avondale similar prices for similar parts, in most instances, the bidding procedures were simply ignored. The Avondale purchasing agents and warehousemen would divide sales amongst the participating vendors allowing each to charge the same inflated costs to cover the kickback payments.

Q5. The extent to which an established "kickback rate" exists in California and in other areas of the country?

A. There is no real established kickback rate at Avondale but only what the employees and vendors believed that the market would bear.

Q6. The positions held by employees of prime contractors who typically are involved in subcontractor kickback and bid-rigging schemes?

A. The employees at Avondale primarily involved in the kickback schemes had exclusive control over either buying of supplies and services, ordering such services and supplies, or authorizing payment of invoices by Avondale. In those areas where the employee was engaged in the kickback scheme, either there was no internal auditing system by a prime contractor to detect such fraud, or those persons charged with such review were involved in their own schemes and simply tolerated the conduct. In the example of the maintenance superintendent's scheme, that superintendent forged the name of his direct supervisor on the majority of the false invoices. Though the supervisor claimed not to have detected the fraud, that person was also involved in a similar kickback scheme where he received funds from vendors who were permitted to submit false invoices to recoup those payments.

Q7. Whether there are "roving" buyers who move from company to company, maintaining corrupt subcontractor relationships?

A. Most of the buyers at Avondale had been with the company for a lengthy period of time and had not been employed by other defense contractors.

Q8. The extent to which upper management officials of prime contractors are aware of subcontractor kickback and bid-rigging schemes?

A. In the kickback schemes discovered by our investigation, upper level management people, i.e. vice-presidents of the various departments, did not appear to be involved. These executives were not essential to the scheme where low level employees earning low salaries, had no reason to include such personnel or share in the fraudulent proceeds.

Q9. The reasons that prime contractors may fail to detect subcontractor kickbacks and to inform law enforcement officials about corrupt employees and subcontractors?

A. Widespread abuse throughout the entire company appears to be the main reason why the kickback activities of Avondale were not discovered, turned over to law enforcement authorities, and prosecuted. In many instances, lower level employees involved in these schemes had other relevant information relating to schemes of false invoicing by other personnel at Avondale. The chief of security, a vice-president, had submitted false expense vouchers to recoup the payment of campaign contributions. This crime was

uncovered during the investigation. Indeed, it was not until the investigation was well underway that Ogden Corporation, Avondale parent company, brought the results of their internal audit showing excess use of welding materials to the Government's attention. Moreover, Avondale had terminated the Accounts Payable Supervisor because of double billings with an Avondale vendor and this too was not brought to the Government's attention until 6 months later when the federal investigation was ongoing.

The Avondale situation was first brought to our attention by the Jefferson Parish Sheriff's Department. They had been notified by the vice-president in charge of security that there were thefts by an ex-employee from the Avondale Petty Cash Fund. This information came to him as a result of a complaint by a woman who had been jilted by one of the participants in the theft scheme. When the Sheriff's Department realized the scope of fraud at Avondale they brought the matter to my office.

Q10. The extent to which subcontractor kickbacks and attendant bid-rigging schemes increase procurement costs to the Department of Defense?

A. As explained, in some instances, the vendors who paid kickbacks or rendered services to Avondale employees were permitted to recoup those payments or the expenses of those services by submitting false invoices that were charged directly to government contracts, and of course, increased procurement costs. In most instances relating to the welding and maintenance departments, the

false invoicing in the indirect cost area also increased the government's procurement costs since these indirect charges were allocated to the various contracts at Avondale which included substantial government contracts.

Q11. The criminal statutes that are most often used in subcontractor kickback and bid rigging cases?

A. In the Avondale prosecutions my office has employed the conspiracy and mail fraud statutes in dealing with the information which has been uncovered. 18 U.S.C. §§ 371 and 1341. We have employed these sections both because they carry penalties of five years per count and because the types of schemes which we uncovered were most susceptible to prosecution under those sections. The mail fraud statute encompasses any kind of fraud for which the United States mails are utilized. It can include schemes where, as at Avondale, the fraud included depriving Avondale of the honest and faithful services of its employees as well as defrauding potential competitors of the opportunity to compete in business. So long as the parties to these schemes do not employ exclusively private letter carriers, such as Federal Express, the mail fraud statute provides the greatest flexibility in attacking the problems of kickbacks in the Avondale situation. Further, most recipients of the kickbacks were charged with tax violations pursuant to Title 26, United States code, Section 7206(1), since these proceeds were not reported. The Internal Revenue Service and Federal Bureau of Investigation joint investigation has proved

most effective in reviewing the enormous numbers of financial documents, in preparing schedules of the kickbacks, and in working out restitution payments with the defendants.

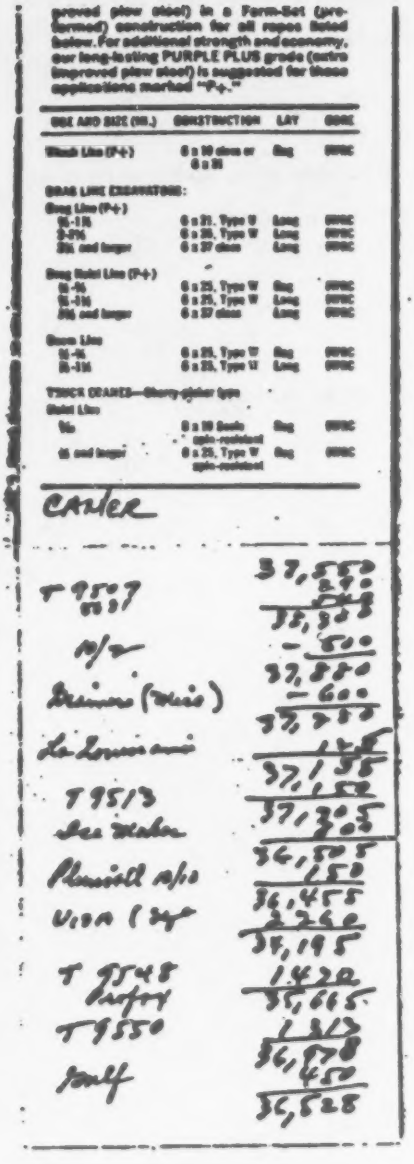
Q12. The extent to which the Anti-Kickback Act, 41 U.S.C. 51, is used in federal prosecutions and any problems that have arisen in using it to prosecute subcontractor kickback cases?

A. Will be addressed by Department of Justice.

Q13. Whether the Anti-Kickback Act should be amended and, if so, what improvements should be made?

A. Will be addressed by Department of Justice.

ENTRIES FROM KICKBACK BOOK



proved plow steel) in a Form-Set (pre-formed) construction for all ropes listed below. For additional strength and economy, our long-lasting PURPLE PLUS grade (extra improved plow steel) is suggested for these applications marked "P+."

SIZE AND SIZE (IN.)	CONSTRUCTION	LAY	CORE
Winch Line (P+)	6 x 19 class or 6 x 36	Reg	IWRC
DRAG LINE EXCAVATORS:			
Drag Line (P+)			
1/2-1 1/8	6 x 31, Type V	Long	IWRC
1-3/16	6 x 36, Type V	Long	IWRC
3/16 and larger	6 x 37 class	Long	IWRC
Drag Hoist Line (P+)			
1/2-5/8	6 x 25, Type V	Reg	IWRC
1/2-1 1/8	6 x 25, Type V	Long	IWRC
3/16 and larger	6 x 37 class	Long	IWRC
Boom Line			
1/2-5/8	6 x 25, Type V	Reg	IWRC
1/2-1 1/8	6 x 25, Type V	Long	IWRC
TRUCK CRANES—Heavy-duty type			
Hoist Line			
1/2	6 x 19 Seale, galv.-reinforced	Reg	IWRC
1/2 and larger	6 x 25, Type V galv.-reinforced	Reg	IWRC

CARLER

37,550
2.50
37,302
- 500
36,802
- 600
36,202
1.45
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150
36,455
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35,615
1317
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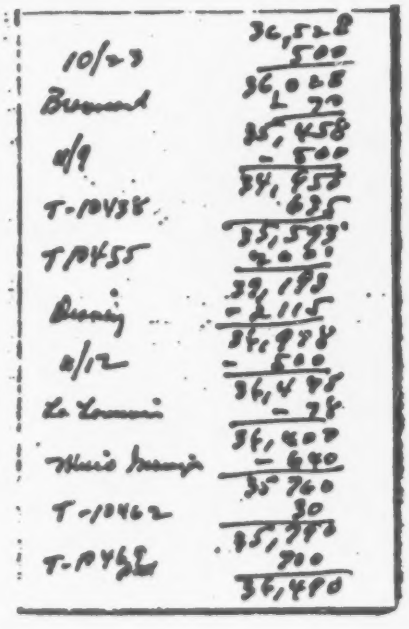
450
35,528



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36,028
35,458
- 500
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35,593
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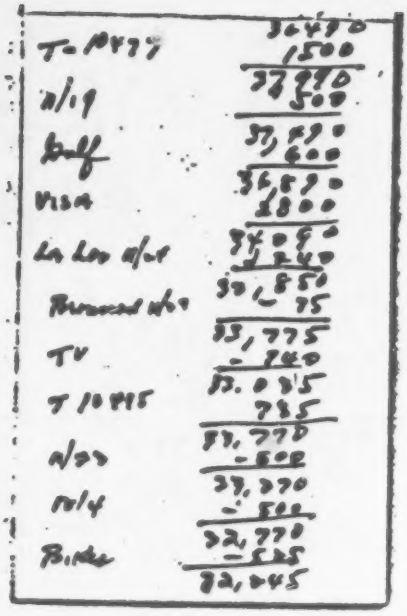

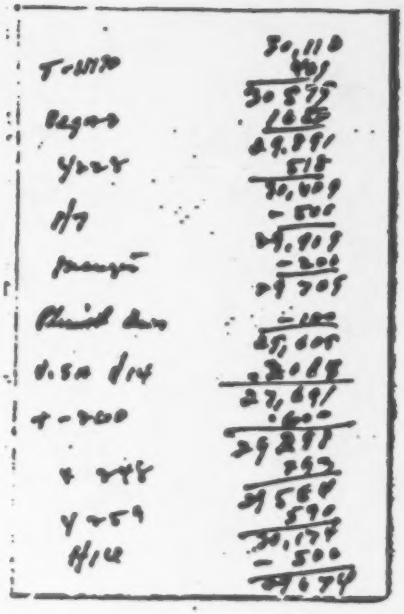

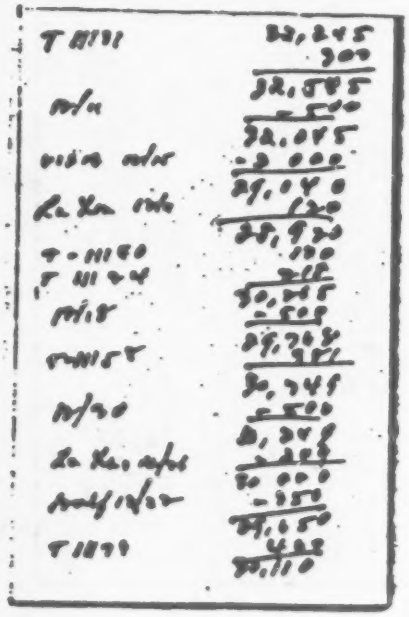

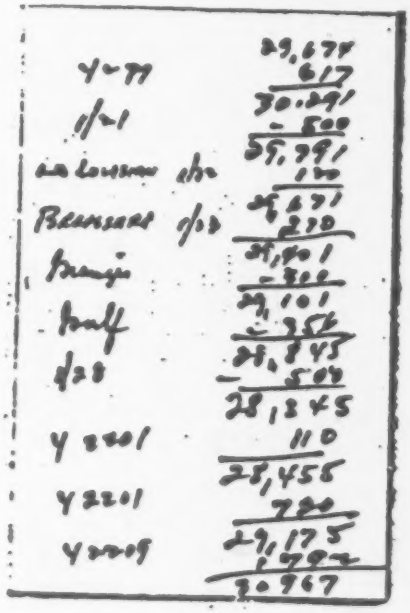

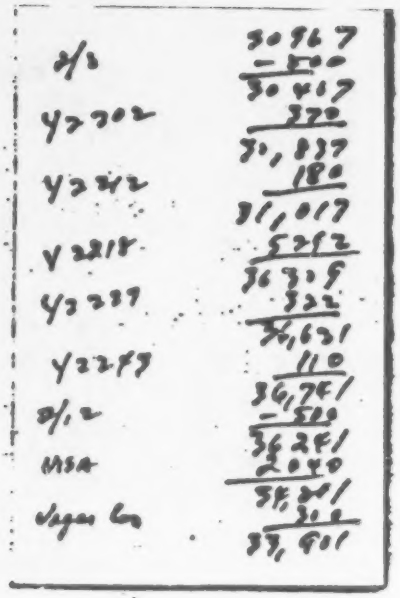

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d/d	− 500
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y2342	180
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y2289	332
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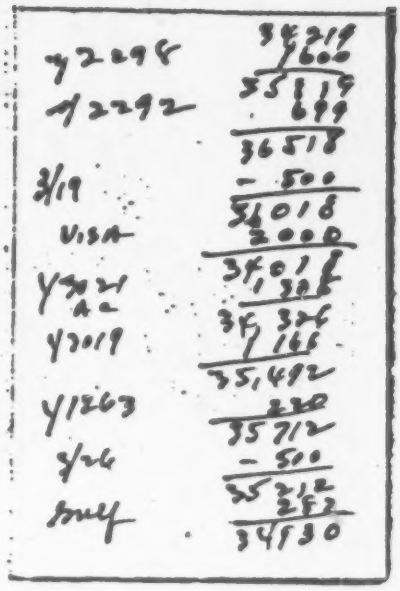
d/c	− 500
	36,211
visa	2040
	38,251
Vegas Co	310
	38,561



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3/19	− 500
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visa	2000
	35,818
y3021	1,328
A2	37,146
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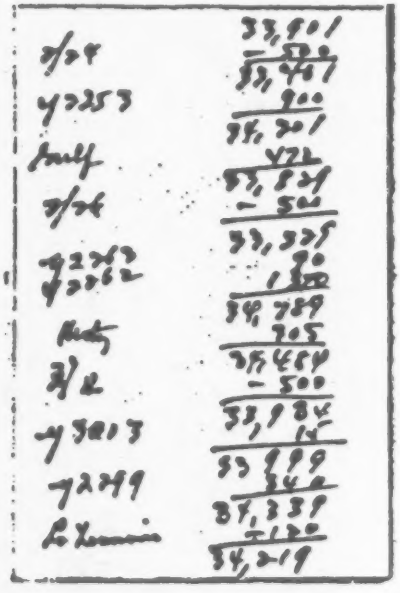
	38,312
y1263	230
	38,542
y/c	− 500
	38,042
Smith	252
	38,294



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d/d	− 500
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y2252	90
y2262	1,500
	35,811
Hardy	705
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3/2	− 500
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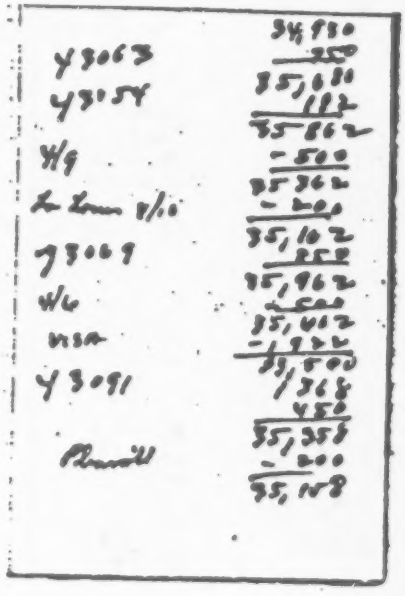

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y3069	252
	34,914
4/6	− 500
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visa	− 1,914
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Russell	450
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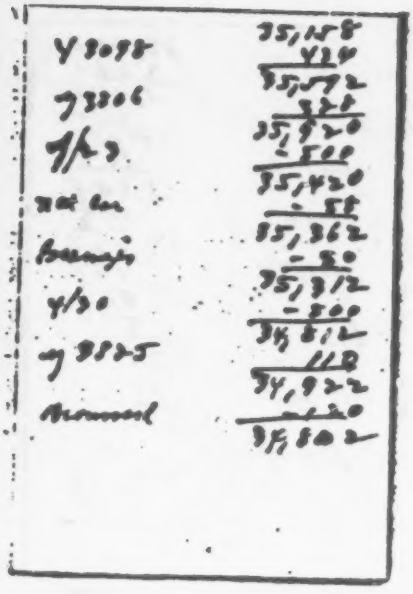

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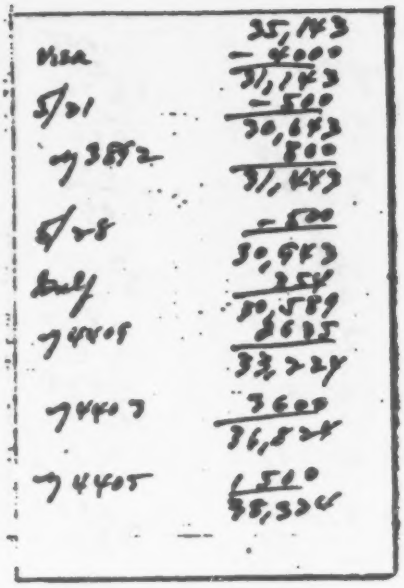

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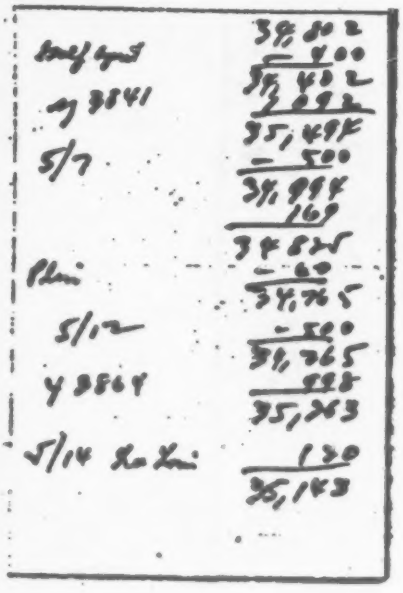

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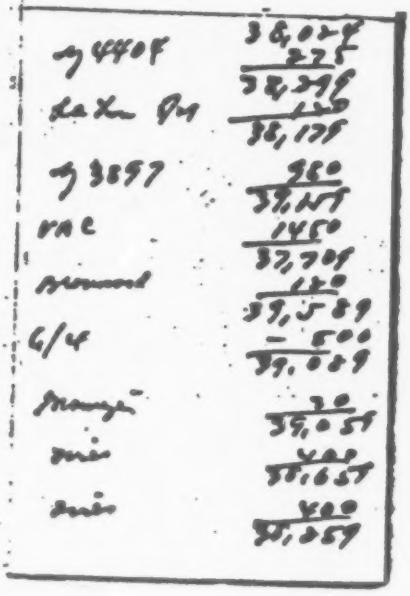

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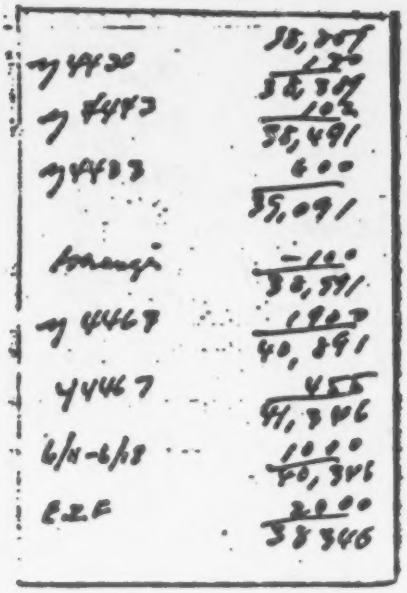

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ग्य ४४३०	1200
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ग्य ४४४३	102
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ग्य ४४४३	600
	35,091
[illegible]	-100
	34,991
ग्य ४४६१	1900
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४४६७	455
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६/८-६/१	1000
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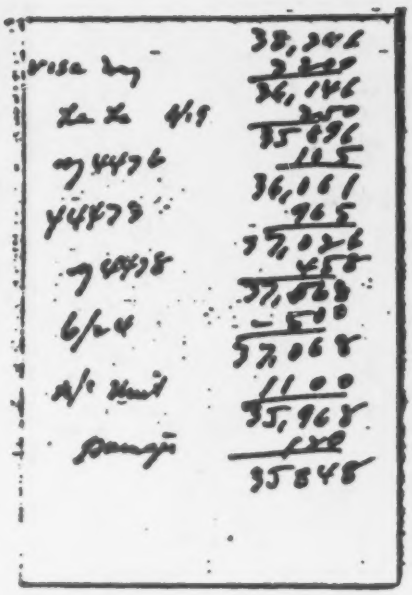

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Visa Inv	2800
	36,146
Lu Lu ४/१	2650
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ग्य ४४७६	105
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४४४७३	965
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ग्य ४४४८	455
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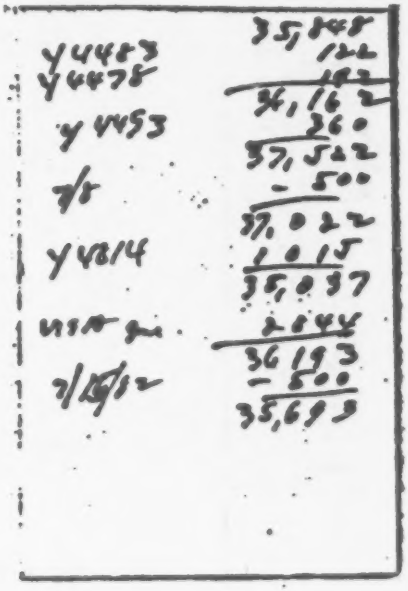

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४४४३	122
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	37,022
४४१४	1015
	35,037
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	36193
४/[illegible]२	-500
	35,693

PREPARED STATEMENT OF JEFFREY J. JAMAR

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, I AM PLEASED TO APPEAR TODAY TO DISCUSS THE FBI'S EXPERIENCE REGARDING THE PROBLEM OF SUBCONTRACTOR KICKBACKS IN THE DEFENSE INDUSTRY. ACCOMPANYING ME TODAY IS SPECIAL AGENT JOSEPH SHEEHAN OF THE FBI'S LOS ANGELES DIVISION. SPECIAL AGENT SHEEHAN, AT THE REQUEST OF SEVERAL DEFENSE CONTRACTORS, HAS ADDRESSED GROUPS SEEKING TO HEIGHTEN AWARENESS OF THE PROBLEM OF SUBCONTRACTOR KICKBACKS.

THE BUREAU'S ASSAULT ON WASTE, FRAUD, AND ABUSE IN GOVERNMENT PROGRAMS AND PROCUREMENT HAS RESULTED IN AN INCREASED INVESTIGATIVE COMMITMENT IN ALL AREAS OF GOVERNMENT FRAUD, BUT ESPECIALLY IN THOSE MATTERS IMPACTING ON THE DEPARTMENT OF DEFENSE. THE FBI, IN CONJUNCTION WITH THE DEPARTMENT OF DEFENSE INSPECTOR GENERAL, HAS MADE PROCUREMENT FRAUD AND ITS ATTENDANT KICKBACK SCHEMES A TOP PRIORITY.

BECAUSE OF THE INABILITY OF ANY ONE CONTRACTOR TO BE ABLE TO DO ALL THINGS ON ALL CONTRACTS, SUBCONTRACTING IS A NECESSARY WAY OF DOING BUSINESS. AS WEAPONS SYSTEMS AND PROCUREMENT PACKAGES HAVE EVOLVED INTO COMPLEX AND HIGHLY TECHNICAL PRODUCTS, THE VULNERABILITY TO CORRUPTION IN A CONTRACTOR'S PROCUREMENT SYSTEM IS SIMILARLY INCREASED.

THE FBI HAS NOTED A PATTERN IN WHICH MAJOR VIOLATIONS INVOLVING SUBCONTRACTOR KICKBACKS DEVELOP IN GEOGRAPHIC LOCALES WHERE DEFENSE CONTRACTORS ARE CLUSTERED. THE CLUSTERING OF MAJOR

CONTRACTORS NATURALLY ATTRACTS A SIMILAR GROUPING OF SUBCONTRACTORS. THE PROXIMITY OF THESE COMPONENTS-OF THE PROCUREMENT PROCESS FACILITATES THE DEVELOPMENT OF KICKBACK SCHEMES. SIGNIFICANT PROBLEMS HAVE BEEN IDENTIFIED IN NEW ENGLAND, THE MIDWEST, SOUTHERN CALIFORNIA AND OTHER AREAS.

THE CORRUPTION PRINCIPALLY MANIFESTS ITSELF IN THE FORM OF KICKBACKS FROM VENDORS AND SUBCONTRACTORS TO PRIME CONTRACTOR'S "FIRST LINE" BUYERS, ALTHOUGH ON OCCASION, RECIPIENTS INCLUDE SUPERVISORS IN THE PURCHASING DEPARTMENTS, ENGINEERS, AND TO A LIMITED EXTENT, UPPER MANAGEMENT OF THE PRIME CONTRACTOR. THE "FIRST LINE" BUYERS SPEND A SIGNIFICANT PORTION OF THEIR TIME IN THE FIELD VISITING THE FACILITIES OF SUBCONTRACTORS, THEREBY BROADENING THEIR EXPOSURE TO KICKBACK APPROACHES. THE BASIC ANNUAL SALARIES OF THESE BUYERS RANGE FROM $25,000 TO $50,000.

TYPICALLY, THE AMOUNT OF KICKBACK PAID IS KEYED TO THE FACE AMOUNT OF THE CONTRACT. GENERALLY IT IS BETWEEN 2 AND 10 PER CENT WITH HALF PAID "UP FRONT" AND THE BALANCE PAID AT THE TIME SUBCONTRACT PERFORMANCE IS COMPLETED OR FINAL PAYMENT IS MADE BY THE PRIME CONTRACTOR. THROUGH THE RECEIPT OF KICKBACKS, CORRUPT BUYERS HAVE BEEN ABLE TO ENHANCE THEIR INCOMES FROM $3,000 TO $100,000 PER YEAR. THE EXACT AMOUNT DEPENDS UPON THE SIZE OF THE SUBCONTRACTS THEY LET, THE FREQUENCY THAT THEY DO SO, AND THEIR WILLINGNESS TO DO BUSINESS WITH SUBCONTRACTORS WHO WON'T KICKBACK.

JUST ABOUT ANY TYPE OF SUBCONTRACT FOR GOODS OR SERVICES CAN BE SUBJECTED TO THE WIDE VARIETY OF KICKBACK SCHEMES. HOWEVER, CONTRACTS INVOLVING DESIGN WORK OR RESEARCH AND DEVELOPMENT ARE MORE VULNERABLE TO KICKBACKS IN THAT SPECIFICATIONS CAN BE DRAWN SO NARROWLY THAT SUBCONTRACT AWARDS ARE VIRTUALLY GUARANTEED TO A CERTAIN VENDOR. THE BASIC KICKBACK SCHEMES RUN A WIDE GAMUT AND INCLUDE DIRECT CASH PAYMENTS, MERCHANDISE, ALL EXPENSE PAID TRIPS, TICKETS FOR SPORTING EVENTS, AND FREE USE OF VENDOR'S CREDIT CARDS. MORE SOPHISTICATED SCHEMES UTILIZE FALSE BILLINGS AND SHELL CORPORATIONS TO CONCEAL PAYMENTS.

SOME SCHEMES INVOLVE BID RIGGING AMONG THE VENDORS TO ALLOCATE FUTURE CONTRACTS AMONG THEIR INFORMAL "CARTEL." THROUGH SCHEMES TO HAVE "COURTESY BIDS" SUBMITTED TO THE PRIME CONTRACTOR, SUBCONTRACT COSTS ARE ARTIFICIALLY INFLATED TO ENABLE THE WINNING BIDDER SUFFICIENT PROFIT MARGIN TO MAKE KICKBACK PAYMENTS. IN OTHER CASES, THE BUYERS WILL PROVIDE COMPETITIVE BID PRICE DATA DIRECTLY TO A VENDOR IN ORDER TO INSURE AN AWARD.

ALTHOUGH SCHEMES CAN INVOLVE TOP MANAGEMENT, NORMALLY THEY DON'T BECOME AWARE OF KICKBACK SCHEMES UNTIL ALERTED BY A CONSCIENTIOUS OR DISGRUNTLED EMPLOYEE, BY A GOVERNMENT AUDITOR, OR BY A LAW ENFORCEMENT AGENCY INVESTIGATING THE MATTER. THE USE OF THE SAME SUBCONTRACTORS GENERALLY DOES NOT AROUSE SUSPICION BECAUSE EVEN LEGITIMATE BUYERS FREQUENTLY RELY ON THE SAME PROVEN

SUBCONTRACTORS WHEN LETTING BIDS. IT IS NEARLY IMPOSSIBLE TO DETECT KICKBACKS SOLELY THROUGH REVIEWS OF PAPERWORK AND SYSTEMS, BECAUSE THE SCHEME CAN BE CONCEALED EASILY BY A KNOWLEDGEABLE BUYER WHO TAKES THE TIME TO GENERATE THE PAPERWORK THAT CREATES THE APPEARANCE OF A COMPETITIVE BIDDING ENVIRONMENT. FURTHERMORE, DECENTRALIZED PURCHASING SYSTEMS FACILITATE BUYERS CREATING THEIR OWN NETWORKS AND ENTERING INTO NUMEROUS ILLEGAL ARRANGEMENTS.

IN THE PAST WHEN TOP MANAGEMENT BECAME AWARE OF THE KICKBACK SCHEMES, THE SUSPECT EMPLOYEES USUALLY WERE FIRED OR ALLOWED TO RESIGN. MANAGEMENT WAS SATISFIED THAT THEY WERE RID OF A PROBLEM EMPLOYEE. GENERALLY, LAW ENFORCEMENT WAS NOT NOTIFIED BECAUSE OF A FEAR OF ADVERSE PUBLICITY AND THE POSSIBILITY THAT SUCH REPORTING WOULD SUBJECT THE COMPANY TO INDICTMENTS OR SUSPENSION AND DEBARMENT FROM DOING BUSINESS WITH THE GOVERNMENT. PRIME CONTRACTORS WERE RELUCTANT TO NOTIFY OTHER COMPANIES OF KICKBACK SUSPICIONS BECAUSE OF PERCEIVED LIABILITY ISSUES. FREQUENTLY, THESE CORRUPT EMPLOYEES HAVE BEEN REEMPLOYED WITHIN THE INDUSTRY, WITH VENDORS, OR SET UP THEIR OWN BUSINESS, THEREBY CONTINUING THEIR CORRUPT PRACTICES.

HOWEVER, LATELY, THERE HAS BEEN AN INCREASED WILLINGNESS ON THE PART OF SOME DEFENSE CONTRACTORS, AS PART OF A

NEW "SELF-POLICING" ATTITUDE, TO COME FORWARD WITH INFORMATION ABOUT EMPLOYEE CRIMINAL WRONGDOING. THE RESULTANT PUBLICITY FROM ENSUING PROSECUTIONS SERVES AS A MAJOR DETERRENT TO POTENTIAL KICKBACK SCHEMES PARTICIPANTS AND REDUCES OPPORTUNITIES FOR REEMPLOYMENT IN THE INDUSTRY. AS PART OF THIS INCREASED EMPHASIS ON "SELF-POLICING," A NUMBER OF MAJOR DEFENSE CONTRACTORS ARE TAKING THE INITIATIVE TO COMBAT THE PROBLEM OF CORRUPT EMPLOYEES AND KICKBACK SCHEMES. MANAGEMENT SEMINARS AND EMPLOYEE TRAINING SESSIONS HAVE BEEN USED TO HIGHLIGHT THE PROBLEM AND TO STRESS MANAGEMENT'S DETERMINATION TO TAKE CORRECTIVE ACTION. ONE COMPANY HAS PREPARED A FILM WHICH IS SHOWN TO ALL EMPLOYEES CONCERNING ETHICAL BUYING PRACTICES, AND THE HAZARDS AND PENALTIES FOR ENTERING INTO KICKBACK ARRANGEMENTS. ANOTHER COMPANY HAS INSTITUTED A POLICY OF SENDING QUESTIONNAIRES TO VENDORS SEEKING INFORMATION ON HOW THE VENDOR VIEWS ITS RELATIONSHIP WITH THE COMPANY'S BUYERS AND ENGINEERS, EXPECTING THAT IF KICKBACK SITUATIONS DO EXIST, VENDORS NOT RECEIVING SUBCONTRACT AWARDS WOULD REPORT THEIR SUSPICIONS ON THESE QUESTIONNAIRES.

THE FBI ENCOURAGES THESE CORPORATE EFFORTS TO INCREASE INTERNAL POLICING. THE BENEFITS DERIVED FROM CORPORATE EFFORTS TO EDUCATE PERSONNEL, IMPROVE INTERNAL CONTROLS, AND PERIODICALLY TEST COMPETITIVE DATA WILL FAR OUTWEIGH THE ASSOCIATED COST. IN THE LOS ANGELES AREA, THE FBI HAS BEEN ACTIVELY ASSISTING

EDUCATIONAL PROGRAMS BY DEFENSE CONTRACTORS. PRESENTATIONS HAVE BEEN MADE AT CORPORATE MANAGEMENT SEMINARS IN ORDER TO INCREASE INDUSTRY AWARENESS OF THE MAGNITUDE OF THE KICKBACK PROBLEM AND WAYS THAT CORPORATIONS CAN ASSIST LAW ENFORCEMENT IN THE IDENTIFICATION AND SUBSEQUENT PROSECUTION OF PARTICIPANTS IN KICKBACK SCHEMES.

OFTEN, THE IMPACT ON PROCUREMENT COSTS EXCEEDS THE TYPICAL KICKBACK OF 2 TO 10% OF A CONTRACT VALUE, BECAUSE OTHER COSTS, SUCH AS OVERHEAD, MAY BE CALCULATED USING A KICKBACK INFLATED BASE. BUT, THE IMPACT CAN EXTEND BEYOND THE FINANCIAL COST TO THE GOVERNMENT. CORRUPTION IN ONE PART OF THE SYSTEM FOSTERS CORRUPTION AND DETERIORATION IN OTHER PARTS. DEFICIENCIES IN PRODUCT QUALITY ARE MORE READILY OVERLOOKED. CORRUPT EMPLOYEES ARE MORE EASILY ENTICED BY OTHER OPPORTUNITIES TO GAIN PERSONALLY BY MISUSING THEIR POSITIONS OR SELLING OUT TO OTHER BIDDERS SEEKING TO OBTAIN ILLICIT ADVANTAGE.

THE FBI WILL CONTINUE TO IDENTIFY, INVESTIGATE, AND SEEK PROSECUTION OF THOSE WHO CORRUPT THE PROCUREMENT PROCESS. FURTHER SUCCESS WILL DEPEND ON THE FUTURE AVAILABILITY AND COMMITMENT OF INVESTIGATIVE AND PROSECUTORIAL RESOURCES. CONTINUED DEPARTMENT OF JUSTICE EMPHASIS ON THESE PROSECUTIONS AND TEAMWORK BETWEEN THE FBI AND THE INVESTIGATIVE AND AUDITING COMPONENTS OF THE DEPARTMENT OF DEFENSE AND MILITARY SERVICES IS ESSENTIAL. THIS CONCLUDES MY PREPARED TESTIMONY. MR. SHEEHAN AND I WILL BE HAPPY TO ANSWER YOUR QUESTIONS.

PREPARED STATEMENT OF VICTORIA TOENSING

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear before you today to present the views of the Department of Justice on the Anti-Kickback Act, 41 U.S.C. §§51-54.

The Anti-Kickback Act, as enacted in 1946, prohibited any subcontractor from making a payment or granting a gift to a prime contractor or to a higher-tier subcontractor as an inducement for the award of a subcontract on any cost reimbursement contract. The statute was amended in 1960 so that it now applies to subcontractors under any type of negotiated contract. 1/ It includes two sanctions: (1) civil recovery of the kickback by the United States, and (2) a criminal fine or imprisonment for one who makes or receives a kickback.

The Anti-Kickback Act resulted from government audits of World War II "cost-plus" contracts that revealed payment of commissions or fees by certain firms to prime contractors to obtain subcontracts or orders from the prime contractor. The United States ultimately bore the costs of the kickbacks because, under the terms of the prime contract, the government was required to reimburse the contractor for the costs of all subcontracts.

The legislative history of the Act clearly reveals its original purpose was to establish a civil remedy by which the

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1/ 41 U.S.C. 52 provides in part that "...the term 'negotiated contract' means made without formal advertising."

United States might recover improper expenditures that it might otherwise be forced to absorb. In its enactment of the criminal section of the Act, 41 U.S.C. §54, Congress incorporated the Act's civil provisions into the criminal statute and added a requirement that the prohibited acts be done knowingly. The limited applicability of the statute, however, precludes prosecution of many kickback situations.

In order to bring a successful criminal prosecution under the Anti-Kickback Act, the Government must prove:

1. That the parties are within the class covered by the statute, that is, a subcontractor under a prime contractor or higher-tier subcontractor;
2. That the prime contract was a negotiated contract entered into by any agency or department of the United States for the furnishing of supplies, materials, equipment, or services of any kind; and
3. That there was an acceptance of a payment directly or indirectly by or on behalf of a subcontractor with knowledge of its purpose to induce the award of the subcontract or order, or to acknowledge a subcontract or order previously awarded.

The criminal provisions of the Anti-Kickback Act have not been widely used, as indicated by the relatively few reported judicial decisions. Their infrequent use is due to a number of

problems with the Act, which I will describe momentarily. The Act is limited and applies only to a narrow range of factual situations. Even in some situations where the Act might apply, prosecutors sometimes have available other white-collar criminal statutes with which they are often more familiar, and so they use more familiar tools. Nevertheless, the relatively small number of cases under the Anti-Kickback Act is by no means due to a choice of other statutes. There are several limitations in the Anti-Kickback Act which the Department of Justice thinks should be corrected.

The first and foremost limitation is the Act's requirement that the payment of a kickback be accepted with knowledge of its purpose to induce the award of a subcontract or order, or as an acknowledgement of a subcontract or order previously awarded. This limitation precludes the prosecution under the Act of kickbacks paid by a subcontractor to a prime contractor that are not related to the award of a specific subcontract. For example, this limitation precludes the prosecution of a subcontractor who pays a kickback to obtain information about competing subcontractors' prices, specifications, suppliers, and delivery schedules. It would also preclude prosecution in a situation where the subcontractor has paid a kickback to obtain acceptance of items that have not been tested as required, or items that do not meet specifications or are otherwise defective. Moreover, the Anti-Kickback Act does not apply to under-the-table payments made to obtain modifications of negotiated contracts previously awarded or to change orders to existing contracts. While paying

kickbacks in these situations clearly assists the subcontractor unlawfully, such payments are not made to induce a subcontract or order. We think the Act should expand the prohibited purposes for which a kickback is made to include paying kickbacks in situations of this type. Specifically, the Act should be amended to include kickbacks for the purpose of obtaining information about competitors, for the purpose of pricing contract modifications, altering the terms of a contract, or accepting substandard products.

The Act's second limitation is that it only applies to kickbacks paid in connection with "negotiated" contracts. In practice, a "negotiated" contract is one in which the terms, price, and conditions are subject to discussions between the Government and the contractor. Consequently, the Act does not prohibit kickbacks on contracts that the government awards on the basis of sealed bids, that is fixed price contracts that are not subject to negotiation as to price. Although the harm to the Government is more apparent in "negotiated" contracts, subcontractor kickbacks to a prime contractor on sealed bid contracts are a serious problem. The Government is harmed because the amount of the kickback is passed along in the subcontractor's price to the prime contractor. Ultimately, the kickback is funded by the taxpayer. Moreover, kickbacks in "negotiated" contracts inflate the subcontractor's pricing history that may be used in negotiating follow-on contracts, as well as in change orders and modifications of an existing contract. The Anti-Kickback Act should be amended so that it applies to all contracts between the

United States and its prime contractors, not just to "negotiated" prime contracts.

Third, the Act does not prohibit the offer or solicitation of kickbacks. Thus, the Act does not apply in undercover operations and other situations where the offer or solicitation is clear, but payment has not been made. It should be amended to correct this deficiency.

Fourth, the Anti-Kickback Act does not apply to bid-rigging because at this point there is, as yet, no prime contractor holding a negotiated contract. Thus, the Act would not apply where competitors agree among themselves that one of them will submit to the Government a lower bid than the others and, if he obtains the contract, will award a profitable subcontract to a competitor who has submitted a "losing" bid. The kickback in this situation actually goes from the prime contractor to the subcontractor and is the value of the subcontract. The Act should be amended to cover this type of kickback in connection with bid-rigging.

Fifth, the Act has a relatively light penalty structure. 41 U.S.C. §54 provides for imprisonment for only two years and a $10,000 fine. Of course the fine levels have been substantially increased by the Criminal Fine Enforcement Act of 1984, P.L. 98-596. The Fine Enforcement Act applies to offenses committed after December 31, 1984. Among other things it added a new section 3623 to title 18 providing that an individual convicted of a felony is subject to a fine of the greatest of (1) the amount specified in the law setting out the offense, (2) double

the amount of any gain by the defendant or of any loss by any other person, or (3) $250,000. For defendants other than individuals -- corporations, for example -- the maximum fine for a felony would be the greatest of (1) the amount set out in the offense, (2) double the gain or loss, or (3) $500,000. Nevertheless, the two year prison term for violations of the AntiKickback Act is out of line with other federal fraud and corruption statutes which typically provide for imprisonment for five years or more. The Act should be amended to raise the maximum term of imprisonment and, if the Congress does so, it would be appropriate to state the maximum fine by reference to 18 U.S.C. 3623.

In view of these problems with the Anti-Kickback Act it is not surprising that prosecutors have often relied on other theories of prosecution in kickback cases. Two of the most frequently used statutes are the mail fraud statute, 18 U.S.C. 1341 and the conspiracy statute, 18 U.S.C. 371. Cases involving these statutes proceed on the theory that in making and receiving kickbacks the defendants have defrauded the Government of the unimpaired operation of the procurement process.

Although the mail fraud and conspiracy statutes have provided reasonable alternatives to the Anti-Kickback Act in some instances, they may not always be applicable. Therefore, the Anti-Kickback Act should be amended to eliminate the problems I have described. Specifically, the scope of the Act should be broadened so that it covers kickbacks paid for purposes other than the award of a particular contract or order. The Act should

also include kickbacks under all types of contracts, not just "negotiated" prime contracts. The Act should be amended to cover the offer or solicitation of kickbacks, it should be made applicable to bid-rigging, and the maximum term of imprisonment for violations should be increased.

As I mentioned earlier, the Anti-Kickback Act contains both criminal and civil provisions. The current statute presumes, for civil purposes that the costs of the kickback are passed on to the Government. However, the statute allows the Government to recover civilly only the amount of the kickback. It should be amended to provide that the Government can recover double the amount of damages it sustained, or double the amount of the kickback, whichever is greater. In addition, for civil purposes, the statute should specify a six year statute of limitations similar to that in the Civil False Claims Act, 31 U.S.C. §3731.

Moreover, Mr. Chairman the problem of kickbacks is not confined to contracting in the defense industry. There are many instances of kickbacks which directly affect the taxpayer in other areas. For example, the Department has found many incidents of kickbacks paid to obtain contracts for the repair of properties held by the Department of Housing and Urban Affairs as part of its large inventory of foreclosed mortgages, payments to obtain Federal Emergency Management Agency contracts for temporary shelter for the victims of floods and other disasters, and payments to obtain contracts awarded by the recipients of federal grants under job training, school lunch, and other

similar programs. These are kickbacks but generally are not reached by the present statute. We recommend that the Congress consider correcting this anomaly by generally prohibiting kickbacks to obtain contracts that are funded by federal grants or loans, or under other federal programs.

Finally, while we are on the general subject of bribery, I would like to take this opportunity to urge Congress to consider the Administration's proposed Bribes and Gratuities Act of 1985, S. 1675. As you probably know, this bill was introduced by Senator Thurmond for himself and Senators Biden, East, Hatch, Laxalt, and McConnell on September 20, 1985. It would codify and strengthen existing federal case law to permit the government to void any contract or grant obtained through bribery. Under the Administration's proposal, the Government could either keep any benefits it had received under the tainted contract without obligation, or it could assess the party guilty of bribery with a civil fine of up to ten times the amount of the bribe.

Mr. Chairman, that concludes my prepared testimony and I would be pleased to answer any questions the Subcommittee may have.

PREPARED STATEMENT OF TOM B. CARVEY, JR.

Mr. Chairman and members of the committee, I am Tom B. Carvey, a Vice President of the Hughes Aircraft Company, currently assigned to the Missile Systems Group. From August 1982 through December 1985 I served on the corporate staff as Staff Vice President for Materiel. In that capacity I had broad cognizance over all of the procurement activities of the company.

Hughes is deeply dependent on its suppliers for overall success. We promote active reliance on suppliers who can contribute a competitive edge to our products and systems. In 1985, Hughes' purchase commitments were in excess of $2.3 billion. Hughes offers to its customers extremely diversified product lines, requiring the purchase of a wide variety of products and services, from high technology to the more ordinary.

Your letter of February 7, 1986 inviting this appearance requests me to address eight issues:

1. The Problem: Kickbacks to Buyers

In November 1983, Materiel Management at one of our major operating Groups, Electro-Optical and Data Systems Group (EDSG), uncovered what appeared to be irregularities in several fabrication procurements. Upon discovery of procedural violations and an allegation of kickbacks and payoffs by outside sources, they called Hughes internal Security which conducted a preliminary investigation. The results led directly to the Company's notifying the Federal Bureau of Investigation (FBI) on 2 December 1983, because there appeared to be violations of federal statutes and the FBI's investigative support was necessary.

Hughes fully cooperated with the FBI throughout its subsequent investigation. The FBI initiated an undercover operation which led to the indictment of eight Hughes employees, and one each from Northrop and Teledyne. All eight of the Hughes people have pleaded guilty to federal indictment, and their pleas and sentencing have produced many news stories over the past year. We believe that it was our detection and lead which initiated the successful investigation and prosecution of these eight persons.

We certainly believe that the "kickback" problem is a serious one, even if it were confined to our own operations. However, several other companies have been publicly identified as also affected. Further, we have recently interviewed 197 suppliers of outside fabrication services for Hughes, 41 of which indicated some degree of knowledge of kickback activity in this part of the industry.

2. Seriousness and Nature of the Problem

At Hughes, the problem seems to have centered on suppliers performing "outside fabrication" services, which involve the machining and processing of highly complex, precision hardware. While we at Hughes have our own capability in-house to fabricate many of these items, we characteristically maintain capacity only for about 50 percent of such work and subcontract for the other half. While most of these suppliers are located in the Southern California area, we do business with a number who are located in other parts of the country. It is a highly competitive market, and for several years very few of these shops have been operating at their full capacity. Indeed, contrary to popular perception, the increased defense budget has not created a highly prosperous environment and tough, "dog-eat-dog", fixed price competition is the rule.

It was in this environment that the kickback activity occurred among buyers who were sending out engineering drawings for bid. With this kind of work, it is difficult to know with certainty exactly how much a particular job should cost. Even among experts, variances of 10 percent or more are to be expected. Thus buyers who were demanding kickbacks in the 10 percent region were operating in an area where detection of such overpricing was very difficult. On the other hand, suppliers seeking dishonest advantage might find such markups easy to conceal.

In Hughes procurement operations, we feel there are other areas of vulnerability--where it is likewise very difficult to establish what the cost should be. These include construction and rearrangement work on buildings and facilities; the subcontracting of graphics, art services; and sophisticated reproduction work.

We have no evidence or even indications of kickbacks or fraud in the other areas of procurement which make up the vast majority of Hughes subcontracting (e.g. major subcontracting, electronic parts procurement, test equipment, computers and computer software).

Whenever procurement irregularities are detected, Hughes security initiates an internal investigation. Where we see indications of fraud, we immediately notify the FBI and request assistance. Buyers under suspicion often receive new assignments or are placed under close observation. Employees who are indicted are suspended, and those convicted are terminated. Any employee discovered to have violated Company conflict of interest rules, whether or not criminal charges were pursued, are also subject to suspension or termination.

3. Bid Rigging

We have uncovered no direct evidence of bid rigging. However, the U.S. Attorney's sentencing memorandum for the convicted Hughes buyers describes the practice of courtesy bidding, which suggests a form of bid rigging. We are certainly alert to the possibility of such illegal activity.

So far only one supplier has been positively and publicly identified with kickbacks. There can be little doubt that there are others, but investigations by the federal authorities have yet to produce indictments or make public any of the particulars or the names of others who might be involved. We understand that investigations are ongoing.

4. Problems of Detection

Kickback schemes have proved extremely difficult to detect with certainty. Audits are useful, but seldom produce positive proof of fraud. The investigating and prosecuting agencies have confirmed to us that the "paper chase" seldom leads to successful identification and prosecution. However, innovative and penetrating audits do identify areas of vulnerability and lead to more effective preventive measures and procedural improvements. As I have indicated, the FBI used undercover operations to break the recent Hughes cases, and in our judgment, they deserve high commendation for their efforts.

Let me emphasize again that the procurement operations involved in outside fabrication work are anything but routine and straight forward. Achieving low, competitive pricing and rapid, reliable delivery is a test of skill and judgment for the procurement organization. Where there is a history of prior production, the buyers and their supervision have more to work with, but in many cases they are operating with little or no past history as a reference. These difficulties are compounded by the complex, high technology and highly diversified nature of Hughes products.

5. Procedures at Hughes to Detect and Stop Kickbacks

During the past several years, we at Hughes have pursued a comprehensive program aimed at minimizing our vulnerability to fraudulent action while at the same time keeping our business operations timely, effective, and competitive.

A. Basic Procurement Policy

Hughes' procurement system is designed to satisfy the requirements of our prime contracts and good business practices. It is a single system that has been reviewed and approved annually by agencies of the U.S. Government. These reviews measure our performance against detailed standards established by the Department of Defense.

Our procedures are designed to ensure that procurement risks are assessed, correct business decisions are made based on those assessments and auditable procurement files are properly documented to demonstrate that our fiduciary trust has been handled responsibly. We also rely upon such documented experience to assist us in making sound procurement decisions in the future.

To ensure that our system leads us to making sound procurement decisions based on uniformly fair, unbiased and ethical treatment of every current and potential supplier, there are a number of checks and balances built into the system.

Our some 1000 buyers have limited authority to place procurements without prior review by their supervision; and even with their limited authority, they are required to demonstrate through documentation of their procurement files that they have acted within the limits of their authority and in compliance with established procurement practices. For high dollar value procurements, the buyer must obtain supervisory, Materiel management or higher levels of approvals before the award may be made. In addition, depending on the dollar value of the procurement and the risks involved, preaward review is also required by our "watchdog" disciplines: Procurement Analysis and Review; Price/Cost Analysis; and the Subcontract Advisor or Legal Counsel. These disciplines have the dual roles of ensuring that our Company's interests are protected and our procurements are placed in compliance with Company policies, prime contract requirements and Government regulations.

Hughes' system is one of involved collaboration by the various technical and business disciplines outside of Materiel as necessary to ensure that procurements are not only properly placed, but are also well managed after they are placed. For major and critical procurements, Procurement Review Committees are established to ensure these procurements are properly planned and administered. Committee membership includes representatives from all of the technical and business disciplines outside of Materiel as necessary for effective management of the procurement. Their involvement includes formulation of the bidders list, review and approval of the Request for Quotation, evaluation of suppliers' quotations and proposals, establishment of negotiation objectives and participation in negotiations when required, source selection and post award management review and corrective action when required.

Once a procurement is placed, regardless of its size--whether it is a low dollar procurement of a simple item, or a high dollar procurement for a complex item--it is not forgotten in terms of our system of checks and balances. Our Procurement Analysis and Review organizations throughout the Company are charged with the responsibility to perform postaward surveillance activities to check compliance with our policies and to detect violations of those policies and recommend corrective actions to Materiel Management.

Our procurement system, with its well-established checks and balances, discourages unethical conduct. While it is primarily designed to ensure that sound procurement decisions are made in the best interests of the Company and our customers, it is designed to give appropriate protection against violations of our policies and the law.

B. Awareness

We have placed great emphasis on informing and educating our procurement personnel, management, and suppliers, as well as our employees in general, about the threat of dishonest and unethical activity. I am submitting for the record a package of materials representative of our various communications aimed both inside and outside the Company. Our actions have included:

General alert to management

Articles in company newspaper ("Hughesnews")

Articles in supplier version of Hughesnews

Stepped up emphasis on conflict of interest and business ethics

Most people who have not had contact with criminal activity find it difficult to believe or accept that their own employees or colleagues are in fact stealing or accepting bribes. Even when confronted with the fact of kickbacks in a sister organization, they find it hard to believe that it could happen to them. Thus an awareness campaign is essential and must be sustained.

C. Internal Security

At Hughes, we have always maintained professional and effective internal investigative resources. Ours is headed by a director in whom we have the utmost respect and confidence. He is Ed Best, who joined Hughes after 22 years service in the FBI, including three years as special agent in charge of the Los Angeles office, in the period 1980-1982. Further, he was Director of Security for the Summer Olympic Games held in Los Angeles in 1984.

D. Internal Procedures

We have acted vigorously to increase surveillance, change audit patterns, tighten controls, implement personnel rotations, change organizations, and both reduce the number and increase discipline at order release points. Although we complied with the FBI request to suspend our own investigations in order to avoid possible interference, we were able to identify ten employees suspected to be implicated, and we then altered their assignments. Eight of the ten were those indicted. We have continued to cooperate fully with the FBI and U.S. Attorney's office in their investigation of the other two.

As I have previously indicated, senior Hughes materiel management conducted direct interviews with 197 outside fabrication suppliers seeking information and demanding firm commitments not to engage in fraudulent practices. These face-to-face contacts followed prior correspondence specifically inviting any input from the suppliers about unethical or illegal practices. We have also initiated a supplier self-certification program in which each supplier performing outside fabrication or related work is asked to certify his compliance with Hughes ethical standards and to report any departures from those standards by Hughes employees.

All Materiel Practices were subjected to reexamination across the Company and a number of steps were taken to strengthen and improve their effectiveness. Group and Division written directives covering outside fabrication procurement have been issued to strengthen policies.

E. Education

We wrote and published the booklet "Ethics and Buying-A Matter of Integrity". This was distributed to over 55,000 employees with a cover letter from Company President, Don White. In addition over 25,000 copies were distributed to key suppliers in December 1984 under a personalized letter addressed to supplier executives. The letter asks for all suppliers' support of the Company's policy as set forth in the booklet and states: "At any time, should there be questions or any doubt about its meaning or its practice, we ask that you call us at once for clarification".

We produced a ten-minute film/video cassette based on the booklet, again featuring Hughes President, Don White, plus an FBI spokesman. This is used extensively throughout the Company for training purposes, as well as for orientation of new employees. A copy of the video cassette is submitted for the record and possible committee interest.

We continue to create further training aids such as a video cassette to train personnel operating at order release points regarding their obligations of ethical behavior.

Focus on the issues of standards of conduct and ethical behavior continues in communications with suppliers through Company publications such as the Supplier edition of the Hughesnews.

We have established a working relationship with the Ethics Resource Center in Washington D.C. for exchange of materials.

Because acceptance of gifts or gratuities can be an introduction to unethical and illegal practices, we address this issue strongly in our educational materials. An example of our ongoing campaign on this subject is the greeting card sent out to Hughes' suppliers at Christmas 1985 reminding them specifically of our ethics policy prohibiting gifts and gratuities. A letter with the card was also sent to all Hughes supervision and procurement personnel. Part of the message on the card was: "Gifts, entertainment, or any other such gratuities during the holidays-or any other time of the year-are not welcome. Offering them reflects negatively on the supplier who does it. Hughes employees are instructed to refuse such offers and to return anything sent to them".

Materiel supervision and management throughout the Company were subjected to a stepped-up emphasis on conflict of interest and business ethics matters. For example, a Special Agent of the FBI spoke on the subject of "Personal Integrity and the Buying Process" at a senior Materiel Management seminar.

F. Industry and Community

We have spoken out on the subject through media interviews, including the Los Angeles Times and Wall Street Journal.

We have brought the issue before the procurement community represented by industry associations such as the AIA, EIA, MAPI and NAPM.

We continue an outreach program, for example, afternoon and evening sessions on business ethics at the business school of Loyola Marymount University for undergraduates, graduate students, faculty, and alumni.

6. Employment Checks by Other Companies

Most companies limit their response regarding present or former employees to confirmation of dates of employment and perhaps salary level. There is a reluctance to provide more information because of the risk of litigation and potentially severe financial liability rising out of charges which employees can raise claiming a defamation and invasion of privacy. In our litigious society there are many individuals willing to go to court to "assert their rights" and attorneys ready to take on such cases. Businesses across the country face expensive bills for the defense of such matters.

This leads to a disturbing and insidious situation where an employee who is suspected of misdeeds may simply resign and seek employment elsewhere in the industry. The company from which he resigned characteristically has no proof of the misdeed and would proceed at its own peril to state merely its suspicion to another company making an inquiry. We have adopted the practice at Hughes of very thorough checking of references, but under conditions I have described, a thorough reference check does not assure identification of the person who has quit a job at another company under suspicious conditions. We understand that several buyers who quit jobs at Hughes under a cloud of suspicion were readily able to secure employment elsewhere in the aerospace industry.

I note that the industry is even denied access to criminal records, although such records are available to financial institutions and credit firms.

7. FBI Program with Prime Contractors

The FBI has already been very helpful to Hughes, participating in seminars and training films. No doubt they will continue to be helpful to the industry at large, but they are often limited by available resources, as well as the inability to discuss details of ongoing investigations. The U.S. Attorney's office in Los Angeles has also been helpful and cooperative to Hughes within limits of propriety and law which are imposed upon them by their function.

Organizing a "neighborhood watch" within the industry is a tempting thought, but there would have to be strict safeguards against creation of an employment "blacklist" which might unfairly discriminate against innocent persons seeking employment.

8. A Possible Legislative Remedy

If we in industry are to stop illegal practices by unethical persons working in the procurement areas, the so-called "revolving door" must be closed. As long as a person terminated by one defense contractor because of suspicions about participation in kickbacks or other illegal activities can apply for the same type of job at Hughes or elsewhere, without fear that his prior employment activities will be disclosed to and considered by his prospective employer, then industry will be hamstrung in its ability to eradicate this activity.

It is in this area that I believe that federal legislation could be of substantial assistance. An analogy is the Fair Credit Reporting Act, enacted by Congress in 1970. That Act balances the need for the credit and business community to collect and disseminate the credit information necessary for sound business decisions while extending the right to the consumer that the information be relevant and fair. The Act furnishes to those complying in good faith with its requirements some measure of protection from claims of defamation, invasion of privacy and negligence for the content of credit reports. Perhaps similar legislation could be created for the defense industry, enabling the industry to collect and disseminate relevant information regarding the background and employment experience of individuals who work in buying capacities and other sensitive areas of our work. An employee

could be granted a right to access any information that has been collected and disseminated and a right to supplement and correct that information. Employers and prospective employers could more freely exchange necessary information under a definite standard of conduct which would protect them from tort liability under state law and shield them from the enormous costs and risks which litigation of such claims presents. I do not have for you today, a precise formulation of how legislation of this type would work, but I can assure you that we would welcome the opportunity to explore a proposal of this type further with you.

Conclusion: I appreciate this opportunity to address an issue of substantial concern and importance to our industry. We at Hughes stand ready to assist the Government and our industry associates in every proper way to correct the situation which has developed.

In the final analysis, our success at Hughes rests on integrity: the integrity with which we conduct all our business relationships as well as the integrity of our products. Maintaining our integrity is paramount among our objectives.

WILLIAM V. ROTH, JR., DELAWARE, Chairman
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United States Senate
COMMITTEE ON
GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON
OVERSIGHT OF GOVERNMENT MANAGEMENT
WASHINGTON, DC 20510

March 6, 1986

Mr. Tom B. Carvey, Jr.
Vice President
Hughes Aircraft Company
1100 Wilson Boulevard
Arlington, Virginia 22209

Dear Mr. Carvey:

Thank you for testifying before the Subcommittee last Thursday at its hearing on Department of Defense Subcontractor Kickbacks. Once the hearing record is published, we will be sure to send you a copy.

We would appreciate your answering the following questions for the hearing record:

(1) How much money was involved in the kickback schemes that led to the indictments of eight Hughes employees?

(2) Were the bids that were submitted by the subcontractors inflated to cover the cost of the kickbacks paid to the Hughes buyers? If so, by how much?

(3) You discussed the problem of employees suspected by prime contractors of taking kickbacks, resigning and then going to work for another contractor.

Would this be less of a problem if prime contractors contacted federal authorities about the suspected kickbacks rather than trying to handle the problem quietly by simply firing the employee involved?

(4) Debarment or suspension would prevent an individual from doing business with the Defense Department, no matter where he went to work. Also, it seems to me

that most prime contractors would be unlikely to hire a debarred or suspended individual.

Do you believe that the Department of Defense should be more aggressive in debarring or suspending employees indicted for taking kickbacks? Would that help solve the problem of corrupt buyers going from one firm to another?

(5) You mentioned in your statement a survey that Hughes conducted in which you found that 41 of the 197 suppliers interviewed had "some degree of knowledge of kickback activity."

What action, if any, has Hughes taken to follow up on the information gathered as a result of your survey? Did the survey implicate any additional employees of your company?

(6) Hughes, as part of its educational program, has stressed to its employees that they cannot accept gifts from suppliers.

Do you believe that it would be useful for the federal government to require a financial disclosure statement of sorts from certain employees of prime contractors certifying that they have not received gifts or cash from subcontractors?

Please send your response to the Subcommittee on Oversight of Government Management, Committee on Governmental Affairs, 326 Dirksen Senate Office Building, Washington, D.C. 20510.

Thank you again for your testimony.

Sincerely,

William S. Cohen
Chairman

Carl Levin
Ranking Minority Member

WSC:CL:jam

RESPONSE BY MR. CARVEY TO LETTER FROM SENATORS COHEN AND LEVIN, MARCH 16, 1986

Question 1. How much money was involved in the kickback schemes that led to the indictments of eight Hughes employees?

Answer. We don't know. The only facts available to us are those disclosed by the U.S. Attorney's office when charges were filed and during pleas and sentencing. The total dollars in kickbacks disclosed there totalled about $22,000.00 for six defendants. In addition, there were mentioned international travel and an automobile. Because none of the cases went to trial and because of continuing investigations, available information is limited.

Question 2. Were the bids that were submitted by the subcontractors inflated to cover the cost of the kickbacks paid to the Hughes buyers? If so, by how much?

Answer. They must have been—there is no "free lunch" even in the kickback arena. We don't know for certain just how much. Testimony from the FBI and U.S. Attorney's office in Los Angeles describes the "going rate" at between 5 and 10% of the order price. As I have indicated in earlier testimony, the one supplier who has so far been identified as paying kickbacks has told us his payoffs ran about 7% of the annual sales.

Question 3. You discussed the problem of employees suspected by prime contractors of taking kickbacks, resigning and then going to work for another contractor. Would this be less of a problem if prime contractors contacted federal authorities about the suspected kickbacks rather than trying to handle the problem quietly by simply firing the employee involved?

Answer. Let me clarify what may be a misperception of this problem. Whenever we at Hughes actually have reason to believe that kickbacks are being paid to an employee, we always and promptly go to the FBI to report and to seek help—and I think this is also true for all the other aerospace contractors with whom I am familiar in Southern California.

The problem of buyers resigning and going to work for another neighboring company is more subtle. Often, we do not suspect kickbacks as such, but may simply have noted some sloppy work by a buyer. In one such case, we verbally disciplined the employee and put a record of it in his personnel file. The next week, he resigned. Later, he was one of those indicted and convicted.

Or, here is another example. Suppose we had suspicion of improper employee behavior, but insufficient proof even to sustain firing or reporting for investigation. Remember—we must in fairness presume innocence until we have reliable evidence to the contrary. In such a case, we merely felt uncomfortable about the employee but our concern and diligence about possible dishonesty was so strong that we reassigned the employee to a non-buying job where he or she remained on the payroll but was denied influence on direct buying decisions. In more than one case like this, the buyer simply left the company on his own volition. Some were later indicted and convicted.

One can infer that such buyers are very anxious to avoid having anything negative on their employment record which might draw attention to them. Especially, they do not want to be fired for cause, because the company could exchange that kind of information with other companies to whom they might apply for employment. As long as there is only suspicion or a onetime disciplinary dissatisfaction they could feel safe in seeking another job down the street.

Likewise, if one was taken out of the buying loop, it appears that motivation was strong to move to another job elsewhere where he could get back into "the action."

Thus, in our experience at Hughes, we could not fire any of the eight employees until after their conviction. This was partly because we were asked to withhold such action during the FBI investigation and partly for lack of proof strong enough to sustain discharge. Yet at the time of indictment, only two of the eight Hughes buyers were on our active payroll. (I have already noted in my prior statement to the committee that we acted immediately to suspend each employee on indictment, and to discharge on conviction.)

To get back to the sense of your question, it may indeed be a good idea to report suspicions to Federal authorities, provided there are proper safeguards against damage to innocent persons through wrongful accusations. But it is not so simple as telling the prime contractor not to fire someone without contacting Federal authorities. I don't believe that is the problem.

Question 4. Debarment or suspension would prevent an individual from doing business with the Defense Department, no matter where he went to work. Also, it seems to me that most prime contractors would be unlikely to hire a debarred or suspended individual. Do you believe that the Department of Defense should be

more aggressive in debarring or suspending employees indicted for taking kickbacks? Would that help solve the problem of corrupt buyers going from one firm to another?

Answer. Yes, that should certainly help stop buyers going from one defense contractor to another if the information is properly disseminated in industry. By our experience, DOD has been very alert and has acted with commendable diligence to disbar or suspend those identified with kickbacks. We understand that all eight of our convicted employees are disbarred.

May I note that the 1986 Defense Authorization Act (Public Law 99-145) contains specific provisions in Sec. 932 prohibiting employment in a management or supervisory capacity on any defense contract of a person convicted of fraud or a felony arising out of a defense contract. The committee may want to consider extending such provisions to all persons directly or indirectly involved in buying activities.

Question 5. You mentioned in your statement a survey that Hughes conducted in which you found that 41 of the 197 suppliers interviewed had "some degree of knowledge of kickback activity." What action, if any, has Hughes taken to follow up on the information gathered as a result of your survey? Did the survey implicate any additional employees of your company?

Answer. Throughout the interview process with all 197 suppliers, care was taken to uncover any possible misconduct by Hughes employees. While 41 suppliers acknowledged having some awareness of unethical business practices by other companies in their trade, most of them clearly stated that to the best of their knowledge none of those activities involved Hughes employees. Further, the great majority of suppliers we talked with indicated their dealings with Hughes were very professional and aboveboard.

A small number of suppliers provided information—mostly of a hearsay nature—indicating possible misconduct by Hughes employees. Almost all those named were employees already charged. Upon completion of the entire interview process, a final assessment was made of all interviews, and it was determined that there may be sufficient reason to pursue further inquiry into the comments made by one supplier. This inquiry has been undertaken.

Question 6. Hughes, as part of its educational program, has stressed to its employees that they cannot accept gifts from suppliers. Do you believe that it would be useful for the federal government to require a financial disclosure statement of sorts from certain employees of prime contractors certifying that they have not received gifts or cash from subcontractors?

Answer. I see some pros and some cons. On the positive side, it would help sustain awareness of the problem we have been addressing across a broad section of employees, and give another signal to primes and suppliers about conduct expected of them. We at Hughes already require a periodic certification of our procurement personnel for adherence to ethical and legal requirements.

On the other hand, handling formal disclosure statements for a large number of people is an administrative burden to the prime and the government that generates cost. The question is whether the expected benefits justify the cost. A sworn statement can generate resentment among employees who see themselves as singled out to take a special oath of honesty. Identifying the employees who should be required to make such disclosure is not an easy task. The list would reach far beyond just the buyers and procurement organization. Personnel engaged in functional disciplines like engineering, manufacturing, quality, computer operations, program management and others are all vitally involved with suppliers from time to time, and substantially outnumber the procurement community. Where would the line be drawn?

Finally, there is the question of effectiveness—would it serve as a significant deterrent to unethical or illegal conduct? Those willing or eager to accept kickbacks would likely not hesitate to sign such a disclosure statement, however falsely.

Personally, I would place a higher priority on additional funding directed to the FBI for investigative and educational effort aimed at increased prevention, detection and prosecution, rather than pay for the generation of more paperwork expense in defense procurement. Especially so, when the return on investment is questionable.

TEXT OF ANTI-KICKBACK ACT

UNITED STATES CODE ANNOTATED

TITLE 41—PUBLIC CONTRACTS

§ 51. Fees or kick-backs by subcontractors on negotiated contracts; recovery by United States; conclusive presumptions; withholding of payments

The payment of any fee, commission, or compensation of any kind or the granting of any gift or gratuity of any kind, either directly or indirectly, by or on behalf of a subcontractor, as defined in section 52 of this title, (1) to any officer, partner, employee, or agent of a prime contractor holding a negotiated contract entered into by any department, agency, or establishment of the United States for the furnishing of supplies, materials, equipment or services of any kind whatsoever; or to any such prime contractor or (2) to any officer, partner, employee, or agent of a higher tier subcontractor holding a subcontract under the prime contract, or to any such subcontractor either as an inducement for the award of a subcontract or order from the prime contractor or any subcontractor, or as an acknowledgment of a subcontract or order previously awarded, is prohibited. The amount of any such fee, commission, or compensation or the cost or expense of any such gratuity or gift, whether heretofore or hereafter paid or incurred by the subcontractor, shall not be charged, either directly or indirectly, as a part of the contract price charged by the subcontractor to the prime contractor or higher tier subcontractor. The amount of any such fee, cost, or expense shall be recoverable on behalf of the United States from the subcontractor or the recipient thereof by setoff of moneys otherwise owing to the subcontractor either directly by the United States, or by a prime contractor under any contract or by an action in an appropriate court of the United States. Upon a showing that a subcontractor paid fees, commissions, or compensation or granted gifts or gratuities to an officer, partner, employee, or agent of a prime contractor or of another higher tier subcontractor, in connection with the award of a subcontract or order thereunder, it shall be conclusively presumed that the cost of such expense was included in the price of the subcontract or order and ultimately borne by the United States. Upon the direction of the contracting department or agency or of the General Accounting Office, the prime contractor shall withhold from sums otherwise due a subcontractor any amount reported to have been found to have been paid by a subcontractor as a fee, commission, or compensation or as a gift or gratuity to an officer, partner, employee, or agent of the prime contractor or another higher tier subcontractor. Mar. 8, 1946, c. 80, § 1, 60 Stat. 37; Sept. 2, 1960, Pub.L. 86-695, 74 Stat. 740.

§ 52. Same; definitions

For the purpose of sections 51-54 of this title, the term "subcontractor" is defined as any person, including a corporation, partnership, or business association of any kind, who holds an agreement or purchase order to perform all or any part of the work or to make or to furnish any article or service required for the performance of a negotiated contract or of a subcontract entered into thereunder; the term "person" shall include any subcontractor, corporation, association, trust, joint-stock company, partnership, or individual; and the term "negotiated contract" means made without formal advertising. Mar. 8, 1946, c. 80, § 2, 60 Stat. 38; Sept. 2, 1960, Pub.L. 86-695, 74 Stat. 74

§ 53. Same; power of General Accounting Office

For the purpose of ascertaining whether such fees, commissions, compensation, gifts, or gratuities have been paid or granted by a subcontractor, the General Accounting Office shall have the power to inspect the plants and to audit the books and records of any prime contractor or subcontractor engaged in the performance of a negotiated contract. Mar. 8, 1946, c. 80, § 3, 60 Stat. 38; Sept. 2, 1960. Pub.L. 86-695. 74 Stat. 741.

§ 54. Same; penalties

Any person who shall knowingly, directly or indirectly, make or receive any such prohibited payment shall be fined not more than $10,000 or be imprisoned for not more than two years, or both. Mar. 8, 1946, c. 80, § 4, 60 Stat. 38; Sept. 2, 1960, Pub.L. 86-695, 74 Stat. 741.

PROCUREMENT AWARDS AND SUBCONTRACT AWARDS, FISCAL YEARS 1978–85

[In millions of dollars]

	Procurement awards [1]	Subcontract awards [2]	Subcontracts as a percentage of procurement awards
Fiscal year:			
1978	65,185	17,482	26.8
1979	70,956	21,245	29.9
1980	83,686	25,499	30.9
1981	105,223	33,937	32.2
1982	124,725	35,329	28.3
1983	140,483	39,796	28.3
1984	146,032	47,582	32.5
1985 [3]	84,601	22,967	27.1

[1] Source: Prime contract awards, first half fiscal year 1985, Table 6, DOD prime contract awards to all business and to small business, by procurement program fiscal year 1974–85, p. 25–28. Office of Secretary of Defense, Washington Headquarters Services, Directorate of Information Operations and Reports.

[2] Source: Companies participating in the Department of Defense subcontracting program, fiscal years 1979, 1980, 1981, 1982, 1983, 1984, First half fiscal year 1985. Various pages. Office of Secretary of Defense, Washington Headquarters Services, Directorate of Information Operations and Reports.

[3] First half fiscal year 1985 only.

SUBCOMMITTEE SURVEY TO DETERMINE THE NUMBER OF CONTRACTOR EMPLOYEES—BUYERS AND FIRST-LINE SUPERVISORS—RESPONSIBLE FOR MAKING PURCHASES UNDER DOD CONTRACTS

Contractor	Buyers	Supervisors
10 Largest contractors: [1]		
A	540	60
B	957	158
C	350	70
D	317	77
E	550	53
F	778	111
G	699	87
H	223	43
I	413	83
J	595	85
Total	5,422	827
Additional responses: [2]		
A	139	17
B	75	15
C	167	46
D	88	19
E	643	102
F	140	21
G	34	9
H	20	3
I	105	20
J	2	1
K	12	7
L	25	4
M	108	24
N	20	5
Total	1,578	293

[1] The contractors identified in this group are the 10 that received the largest dollar volume of prime contract awards from the Department of Defense in fiscal year 1984. The contractors are not listed in any particular order.

[2] This information pertains to 14 additional defense contractors who were among the 100 companies receiving the largest dollar volume of prime contract awards in 1984.

This data was compiled by the Senate Subcommittee on Oversight of Government Management during January and February 1986.

DEPARTMENT OF DEFENSE
INSPECTOR GENERAL
WASHINGTON, D.C. 20301

24 FEB 1986

Honorable Carl Levin
Ranking Minority Member
Subcommittee on Oversight
of Government Management
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

I am pleased to have the opportunity to assist the Subcommittee in its examination of problems relating to subcontractor kickbacks in the Defense industry. While my response will deal with the seven issues listed in your letter of February 6, 1986, I will discuss these issues collectively for the sake of clarity.

Subcontractor kickbacks to prime contractors are viewed as a serious problem in the Defense industry. While I do not have any statistical data which would in any way quantify the problem of subcontractor kickbacks within the Defense industry, it is my belief that such practices do represent a problem that we consider one of our top investigative priorities. It is a problem on which the Department of Defense (DoD) and Department of Justice (DOJ) have just recently begun to focus investigative attention, and we have seen a significant increase during the past year in the number of investigations involving illegal kickbacks.

Historically, investigative efforts have been concentrated on the activities of prime contractors in an attempt to combat product substitution, cost mischarging, and other illegal activities at that level. However, the DoD investigative agencies and the Federal Bureau of Investigation (FBI) are now undertaking a series of law enforcement initiatives, in conjunction with DOJ prosecutors, which focus on both subcontractor kickback schemes and bid rigging which may also involve illegal kickbacks. These initiatives include joint investigations with the DOJ Antitrust Division and FBI, as well as education and training efforts to sensitize DoD procurement personnel to the problems posed by bid rigging schemes and subcontractor kickbacks.

In the area of education and training, my office has assembled a publication titled, "Indicators of Fraud in Department of Defense Procurement," which contains chapters

specifically dealing with antitrust violations (collusive bidding and price fixing) and commercial bribery and kickbacks. Over 50,000 copies of this publication have been distributed within DoD. Also, several fraud awareness letters, which are issued periodically for distribution within the DoD procurement community, have highlighted the problems associated with antitrust violations and commercial bribery and kickbacks. In addition to these publications, the DoD investigative agencies and my Office of Criminal Investigations Policy and Oversight conduct fraud awareness briefings for procurement personnel, which include coverage of these same problem areas.

While both subcontractor kickbacks and various bid rigging schemes are viewed as serious problems in DoD, they may not necessarily be viewed as attendant schemes. Generally, bid rigging schemes involve agreements or conspiracies among competitors to fix prices through bid suppression, complementary bidding, bid rotation, market division, or some other form of conduct which limits or eliminates competition and sets prices at a level above that which would be experienced in an open market. In contrast, subcontractor kickback schemes do not involve competitors, and generally involve a subcontractor making a prohibited payment to the prime contractor (or higher tier subcontractor) to induce, or in acknowledgment of, the awarding of a subcontract. (It should be noted that the Department of Transportation (DOT), in its investigations of highway construction bid rigging, has uncovered evidence of "kickbacks" from prime contractors to losing bidders who receive subcontracts or cash in return for complementary high bids.)

Although these are separate and distinct schemes, both have the effect of raising the total contract price and cause additional expense to the Government. In both bid rigging and subcontractor kickback schemes, the Government is paying an artificially inflated price for a product or service as a result of fraudulent costing practices. The degree of this susceptibility may best be quantified through an analysis of the results of the recent DOT bid rigging investigations. In comparing contract costs to engineer's estimates before the DOT investigations versus costs and estimates during or immediately following the height of investigative activity, when one would expect instances of bid rigging to be greatly reduced, DOT noted approximately a 10 percent drop in contract costs. Based upon this analysis, it would appear that both bid rigging and subcontractor kickbacks involving DoD contract schemes could have a significant role in increasing DoD procurement costs. However, as previously stated, no statistical data are available in this area and it would be impossible to make a meaningful estimate as to the total procurement costs which might be affected by these schemes.

An analysis of subcontractor kickback cases, and the legislative and administrative documents dealing with this activity, has disclosed the several areas where changes in the existing legislation would help combat subcontractor kickback schemes.

- The Anti-Kickback Act makes it illegal for a subcontractor to provide a kickback to a prime contractor (or higher tier subcontractor) or his employees to induce or to reward the awarding of a contract to the subcontractor. The original statute was limited to cost-plus-a-fixed fee or other cost reimbursable basis contracts. In 1960, the statute was amended to include all "negotiated" contracts, thus bringing negotiated fixed fee contracts within the scope of the statute. As a result, kickbacks paid by a subcontractor to a prime contractor on a non-negotiated contract, with such costs being built into the prime contractor's bid to the Government, (e.g., fixed fee advertised contract) are outside the scope of the statute. I believe that the statute should be amended to prohibit such payments in connection with any contract entered into by any department or agency of the United States.

- The statute as currently written is limited in scope by prohibiting only those payments, that are made for the purpose of inducing the award of a subcontract, or as an acknowledgment of such a subcontract. While the corruption of judgment of prime contractor employees who are participating in the awarding of subcontracts using Government funds is harmful to the Government's interest, the corruption of judgment of prime contractor employees involved in insuring subcontractor performance under such contracts can be just as damaging. To this end, I believe that the statute should be amended to cover any payment, made by a subcontractor to a prime contractor, with the intent of influencing any action in connection with a Government contract, whether it be during the award phase or during the performance.

- The statute provides criminal penalties of a $10,000 fine and/or two years imprisonment for individuals who make or receive any such prohibited payment. While these individuals are also liable to the United States for the amount paid in violation of the statute, there is no civil penalty, above the amount of the illegal payment, which can be assessed. By comparison, the same type of payments made by prime contractors to Government employees are prohibited by both Title 18, United States Code, Section 201 and Title 10, United

States Code, Section 2207. While the Anti-Kickback Act, at Title 41, United States Code Section 51, may be viewed as a counterpart to Title 18, United States Code 201, in that both provide criminal penalties for improper payments made to influence actions on Government contracts, there is no corresponding statute to Title 10, United States Code 2207, which would impose a civil penalty for such payments. I recommend that such a provision be implemented, either as an amendment to Title 41, United States Code Section 51, or as a separate statute, which would provide civil penalties similar to those in Title 10, United States Code 2207, i.e., exemplary damages in an amount at least three, but not more than ten times the value of the payments/gratuities to the contractor or employee concerned.

Combining the enactment of the above suggested legislative changes with reinforced education/training of DoD employees and enforcement actions currently being taken within the DoD, I believe we could take a major step in combatting the problem of subcontractor kickback schemes and in strengthening the DoD procurement system.

Sincerely,

Joseph H. Sherick
Inspector General

Summary of Recent Subcontractor Kickback
Cases in the Defense Industry
Studied By the Senate Subcommittee
on Oversight of Government Management

June 1986

The following descriptions of selected kickback investigations and convictions during the past 15 years are based upon a review by the Senate Subcommittee on Oversight of Government Management staff of relevant indictments, reports and news articles.

1. Avondale Shipyards, Inc. (Avondale, LA)

Avondale Shipyards, Inc. is a prime contractor in the shipbuilding industry. Over the last two years, a number of Avondale employees and suppliers have been convicted of engaging in kickback and bid rigging schemes; many are currently serving prison terms. The Avondale employees include William Alexander, a department supervisor, Ludvic Chabert, a senior buyer, and Wayne Landry, a warehouse supervisor. The subcontractors include A-C Welding Supply, Inc. (Harahan, LA), Anco, Inc. (Baton Rouge, LA), Branton Insulations, Inc. (New Orleans, LA), Eagle Welding Equipment and Supply Co. (LA), and J. Burns, Inc. (LA). One of these subcontractors had paid weekly kickbacks for eight years, 1977-1984; another had paid regularly for four years, 1976- 1980; a third had paid monthly for four years, 1980-1983; and still another had paid for three years, 1981-1983. These and other kickback and bid rigging schemes at Avondale involved millions of dollars.

2. Brown & Root, Inc. (Houston, TX)

Brown & Root, Inc., a prime contractor, performs construction projects. During 1981 and 1982, two buyers in the Houston office, William Callan and Frank DiDomenico, demanded and received more than $70,000 in cash and gratuities from a California subcontractor, Hydralic Parts & Components, Inc.

The subcontractor paid $5,000 to be included on a bidding list for certain Navy construction projects and additional sums to win contracts to supply equipment and vehicles. To ensure that Hydralic won the awards promised, the buyers provided inside information on competitors' bids. At one point, the kickback demands required Hydralic's president to mortgage his home to raise cash. When Hydralic stopped paying kickbacks, it stopped receiving awards. Two other Houston subcontractors also reported kickback solicitations by these buyers. Callan was convicted after a trial; DiDomenico pleaded guilty.

3. E.I. DuPont Company (Aiken, SC)

E.I. DuPont Company, a prime contractor, operates the Savannah River Plant for the government. On April 9, 1986, the federal government indicted Irene Annalignos Skinitis, a woman who owns several businesses that subcontract with the Savannah River facility, for paying kickbacks to a DuPont procurement employee. She allegedly sent cash payments to the employee's home through Federal Express.

4. Emerson Electric Co. (St. Louis, MO)

Emerson Electric Co. is a prime contractor in the electronics industry. During the period 1974 to 1979, several buyers and purchasing managers accepted cash and other gratuities from four subcontractors located in New York and Michigan. The employees were Edward Escobedo, Terry Gibbs, Neal Hutchins, Robert Ruesing and John Serra (unindicted co-conspirator). The subcontractors were Current Components, Inc. (Smithtown, NY), D-Mont Distributors Corp. (Hauppauge, NY), Prime Source, Inc. (Kings Park, NY), and Reptron/Michigan Electronics, Inc. (Livonia, MI).

Bid rigging was also involved. The employees typically sent three bid solicitations to a single subcontractor who would submit a bid for itself and higher bids from fictitious competitors.

The employees and subcontractors were indicted in 1981 and 1982. The government determined that, due to the kickbacks, it had been overcharged on 173 defense contracts and sought recovery of the overpayments from Emerson. In 1985, Emerson settled the dispute by paying the United States $325,000. The government also filed a civil suit against the subcontractors.

5. Garrett Corporation (Los Angeles, CA)

The Garrett Corporation is a prime contractor in the aerospace industry. In 1985, it discharged between 13 and 17 employees for accepting kickbacks. None of these persons has been indicted to date.

6. General Dynamics Corporation, Shipbuilding Division (Quincy, MA and Groton, CT)

General Dynamics Corporation is a prime contractor in the shipbuilding industry. In 1984 and 1985, two senior management officials of a New York subcontractor, Frigitemp Corporation, pleaded guilty to paying $2.7 million to employees of General Dynamics to obtain work on Navy ships and submarines. The subcontractor officials were Gerald Lee, chairman, and George Davis, senior vice president. The General Dynamics employees who allegedly accepted the kickbacks were P. Takis Veliotis, vice president, and James Gilliland, an aide. Mr. Davis was sentenced to 7 years; Mr. Lee was sentenced to 18 months. Mssrs. Veliotis and Gilliland are fugitives.

7. General Electric Company (Lynn, MA)

General Electric Company is a prime contractor in the electronics industry. In late 1985, at least 10 purchasing employees left GE's facility in Lynn, Massachusetts under suspicion of taking kickbacks. Some resigned; others were fired. On May 9, 1986, the federal government indicted officers of Aster Engineering Corp., one of the largest privately owned machine tool concerns in New England, for compiling a "slush fund" of more than $750,000 to

pay subcontractor kickbacks to GE officials. The indictment identified three GE buyers, Roger Armstrong, Domenic Carota and Michael Shinnick as among those accepting kickbacks. These buyers are among the GE employees that left in 1985.

8. Grumman Aerospace Corporation (Bethpage, Long Island)

Grumman is a prime contractor in the aerospace industry. In 1974, nine employees in the New York office pleaded guilty to accepting $400,000 to $500,000 in cash and other gratuities from seven East Coast subcontractors supplying technical manuals to the Navy. The employees were Olav Andereassen, Angelito Claros, Melvin Cohen, Frank Munafo, Robert Ragozzine, William Sheridan, Raymond Shovelski, Michael Strenk and Thomas Toner. The subcontractors were Burmar Technical Corp., Eastern Technical Services, Inc., Miles Samuelson, Inc., Technical Documentation, Inc., Theil Technical Services, Trilon Research Corp., and U.S. Electronics Publications, Inc.

The employees had established a kickback rate equal to 5 to 10% of a subcontract's face value. They had received payments for years, typically channelling the cash through dummy corporations. Bid rigging was also involved.

9. Hughes Aircraft Company (El Segundo, CA)

Hughes Aircraft Co. is a prime contractor in the aerospace industry. In 1985, eight employees--seven buyers and one supervisor--pleaded guilty to accepting kickbacks from a subcontractor cooperating with the FBI. The employees' names were Phil Kaiser (the supervisor), Joseph Canfield, Daniel Gordon, John Hamilton, William Benitas Huerta, Michael Johnston, Richard Moretine and James Rowe.

In tape recorded conversations, Mr. Kaiser stated that he had received $250,000 in kickbacks in one year while working at Hughes. The subcontractor indicated that he had been paying kickbacks for years.

In 1983, a buyer, Dorando Scrosoppi, who had been hired by Hughes on a temporary basis, pleaded guilty to accepting kickbacks from a subcontractor, Simo Turkich. The buyer had been receiving 10% kickbacks on orders he directed to the subcontractor, as well as 50% of any price increases

resulting from inside information he supplied on competitors' bids.

10. Lockheed Aircraft Corporation,
Missile and Space Division (Sunnyvale, CA)
Shipbuilding Division (Seattle, Washington)

Lockheed is a prime contractor in the shipbuilding and aerospace industries. In 1985, a design engineer for Lockheed, Frederick Gordon, and an independent sales representative, Edward Loeswick, were convicted of engaging in a kickback and bid-rigging scheme with a subcontractor, Edler Industries, Inc., who had been working on the Trident Ballistic Missile Program. The scheme had lasted more than two years, 1981-1983. Mr. Gordon and Mr. Loeswick are now in prison.

11. Northrop Corporation (Los Angeles, CA)

Northrop Corporation is a prime contractor in the aerospace industry. In 1984, over a period of a few months, procurement administrator, Ronald Brousseau, demanded and received $35,000 from a subcontractor cooperating with the FBI. Mr. Brousseau had been assigned to the Stealth bomber project and was supervising several buyers. In a tape recorded conversation, he described a plan to obtain enough kickbacks from his job at Northrop to retire at age 55. He solicited kickbacks equal to 5% of a subcontract price plus 25% of any increase allowed on a low bid. Mr. Brousseau pleaded guilty to accepting a $4,000 bribe and is now in prison.

12. Raytheon Corporation (Lexington, MA)

Raytheon Corporation is a prime contractor in the aerospace industry. In 1984, a program manager, Chet Adamsky, pleaded guilty to accepting cash kickbacks from three subcontractors. The payoffs included $57,000 from Alpha Industries, Inc. (Woburn, MA); $150,000 from Feustal Industries Corp. (Plainview, NY); and $30,000 from Venus Scientific, Inc. (Farmingdale, NY), for a total of $275,000. Mr. Adamsky had also solicited, unsuccessfully, a $50,000 kickback from Eldec Corp. (Lynwood, WA). Mr. Adamsky had apparently planned to channel the payoffs through a dummy corporation.

Mr. Adamsky was sentenced to several years of probation. In 1985, Alpha pleaded guilty to mail

and wire fraud; it was suspended from doing government work until it paid the United States $97,000 in damages.

In 1975, in an unrelated incident, three subcontractors admitted paying regular kickbacks to a Raytheon buyer to obtain government work. One subcontractor had paid these kickbacks for 13 years, 1962-1975; another for five years, 1970-1975; and the third for four years, 1971-1975. The payments had been based on a formula equal to 2-1/2 to 5% of the labor cost portion of a subcontract; they totalled approximately $125,000. In 1976, the buyer pleaded guilty and was sentenced to 3 months in prison with 2 years probation.

13. Singer Company
Singer-Kearfott Division (Wayne, NJ)

Singer Company is a prime contractor with the Defense Department. On March 14, 1986, a senior buyer with the Singer-Kearfott Division, Alfred Mildon, was indicted for accepting kickbacks from three subcontractors, C&S Tool Company (East Hanover, NJ), L.D.L. Precision, Inc. (Plainview, NY) and Geiger Tool & Manufacturing Co. (Passaic, NJ). The subcontractors or their officers were also indicted. The payoffs had allegedly taken place from 1982 to 1984.

14. Teledyne, Inc. (Los Angeles, CA)

Teledyne, Inc. is a prime contractor in the aerospace industry. In 1985, a vice president and general manager of the Camera Systems unit, Richard Floyd Herbert, pleaded guilty to demanding and receiving kickbacks from a subcontractor cooperating with the FBI. He had been channeling payments through a dummy corporation called Profit Maker Enterprises. Mr. Herbert was sentenced to 6 months in prison.

DEFENSE CONTRACT AUDIT AGENCY
ATLANTA REGION
NEW ORLEANS BRANCH OFFICE
P. O. BOX 29532
NEW ORLEANS, LOUISIANA 70129

IN REPLY REFER TO
1.221/RAC/jr/6B486001

30 October 1985

U. S. Department of Justice
United States Attorney Eastern District of Louisiana
Hale Boggs Federal Building
500 Camp Street
New Orleans, Louisiana 70130
ATTN: Harry W. McSherry, Jr.
Assistant U. S. Attorney

SUBJECT: Current Impact of Fraud Investigation of
Avondale Shipyards, Inc.
New Orleans, Louisiana

Dear Mr. McSherry:

In accordance with your 25 July 1985 letter, we are providing the current audit calculated impact of the fraud. We are also providing information on which of the individuals included in your letter are not included in the impact calculation.

	Total Impact	Impact to Govt. Contracts		
		Cost	Interest	Total
Impact Calculated to Date	$5,650,338	$1,058,021	$439,696	$1,497,717
LESS: Impact not Covered by Federal Indictments:				
(Note 1) Petty Cash	1,337,892	122,045		
(Note 2) Maintenance	245,364	54,539		
(Note 3) Collins Roussell	78,277	12,045		
Impact Covered by Federal Indictments	$3,988,805	$ 869,392		

Notes:

1. No federal indictments were issued as a result of the petty cash scheme. It is our understanding that any prosecution involving this scheme will be handled by the State of Louisiana.

2. Audit calculations on the maintenance scheme includes two vendors for which federal indictments were not issued. Invoices for the two vendors, however, were identified as containing forged signatures as evidence of being received.

3. Impact is based on a copy of an indictment furnished by your office; however, Mr.Roussell's name does not appear on the list furnished with your request.

1.221/RAC/jr 30 October 1985
SUBJECT: Current Impact of Fraud Investigation of
Avondale Shipyards, Inc.
New Orleans, LA

Above noted impact does not include the following individuals contained on the list furnished with your request:

A. Harold Thomas Branton
B. Stephen L. Miller
C. William Alexander
D. Larry Ferguson
E. Howard Shepard

Also as requested, we are providing a copy of Audit Report No. 1221-4B130003-022 dated 24 October 1985 on our review of Avondale's Timekeeping and Labor Accounting Practices.

If you have any further questions, please contact Mr. Richard Cudd, Supervisory Auditor, at 504/255-3465.

Sincerely,

for Harold A. Gorbes
PAUL H. PHILLIPS, Branch Manager
New Orleans Branch Office

Attachment: a/s

TEXT OF PAMPHLET

ETHICS AND BUYING—A MATTER OF INTEGRITY (HUGHES AIRCRAFT CO.)

PREFACE

There are many reasons for the success of Hughes Aircraft Company. Certainly our employees, whose richly diverse talents and ingenuity have produced a long history of impressive achievements, are our greatest resource. But we also owe a great measure of our success to our suppliers—the people and firms that contribute so much to our reputation. Over the years we have worked to establish long-term "win-win" relationships with our suppliers, insisting on the best in quality, performance, delivery and price.

To maintain our position of leadership in an increasingly competitive marketplace, we and our suppliers must share an uncompromising dedication to excellence. We must also recognize that no matter how competitive the environment in which we operate, the success of Hughes Aircraft Company rests ultimately on integrity: the integrity with which we conduct all our business relationships as well as the integrity of our products. Maintaining our integrity is paramount among our objectives.

Each year more of our people are getting involved in procurement—advising our purchasing organizations or making decisions that affect the disposition of millions of dollars. And more suppliers are doing business with us all the time. This booklet in intended to help our employees maintain fair, honest and ethical business relationships with our suppliers. These relationships must be based on mutual trust and integrity. It is the only way to do business for Hughes.

DO YOU INFLUENCE THE BUYING PROCESS?

At Hughes, buying involves more than one buyer and one seller at a negotiating table. Thousands of us are involved to some degree on the buying process—and most of us are not buyers.

If you have any influence at all in decisions about what's bought and from whom, you're involved.

You're a components engineer. The drawings you generate list the approved suppliers you have selected, you're involved.

You're in Product Assurance. You decide which suppliers are qualified and which aren't. Influence goes with the territory.

You vend out artwork, typing or printing for our Graphics or Publications departments. Your recommendation of a supplier has a strong influence on who gets the purchase order.

You're in Shipping and you select freight carriers. Or you're a packaging engineer, deciding which supplier's packaging will do the job best. Or you're a programmer, deciding on a software consultant.

Influence. These are just a few examples. If you haven't thought much about the influence you may have on the buying process, think about it now. Even if you can say honestly that you have no such influence in your particular job, remember that you are still involved to some extent—just because you work for Hughes Aircraft Company. Many people you meet will be convinced that a word from you to "the right people at Hughes" will open the doors of opportunity to them. Your daughter's coach with the tool and die shop, for example. Or the sales rep who lives next door.

Some of us are obviously more involved than others. But we are all involved.

WHAT DOES THIS MEAN TO YOU?

We pride ourselves that, on the whole, our people conduct themselves ethically and with propriety in their business dealings, and we believe the same is true of our suppliers. But occasionally employees or suppliers may be tempted to bend or break the rules for some personal advantage.

All Hughes employees are required to conduct Company business with integrity and maintain a high standard of conduct in all business-related activities.

This policy applies to everyone. Period. Following it is a condition of employment. Don't give in to temptation. There just aren't any good excuses.

If you have anything to do with the buying process you must not let yourself be talked into using your influence to favor a particular supplier. You must know the rules and obey them even if a supplier chooses not to.

If there is any indication that a Hughes employee has chosen to break our rules and peddle influence or otherwise "play games" with a supplier, we encourage and expect that supplier to notify Hughes management immediately. All of our suppli-

ers have access to Hughes management and know the people to contact should the need arise.

WHAT IS ACCEPTABLE?

A supplier you've been working with offers you a candy bar from the vending machine. Do you have to turn it down? Of course not.

You have just spent all morning working out a difficult technical problem with a manufacturer's rep who sells powers supplies, and he invites you to lunch. An hour away from the office would give you a much needed break from the technical grind. Do you have to refuse? Not at all. But let your boss know about the invitation.

While our dealings with suppliers need to be totally objective and strictly business, we want to work with them in a friendly atmosphere. Small pleasantries and kindnesses between people who like and respect each other should be part of the business world. But there is a line to be drawn.

Don't encourage suppliers to take you to lunch. If you go to lunch with a supplier, it should be for a good business reason. Also, on many occasions we expect you to pick up the tab on behalf of Hughes, particularly when you are on your home ground.

Avoid fancy dinners or other forms of expensive evening or weekend entertainment. There may be occasions when an exception to this rule is appropriate. For example, participating in a supplier-sponsored golf tournament may be proper. Discuss the matter with your boss. Get management approval first.

You may accept advertising items of nominal value, such as pens, paper weights or memo pads. Any gift, service or consideration of any kind that exceeds nominal value, however, cannot be accepted and must be returned. If you are in doubt about an item, ask your management.

WHAT IS NOT ACCEPTABLE?

You may not solicit or accept any favors or gratuities from anyone Hughes does business with or from any Hughes competitors.

Whether you call them fees or commissions, kickbacks are morally wrong and legally criminal. The price for accepting kickbacks is high: your job, and even criminal prosecution.

Other forms of favor are also unacceptable. Entertainment, trips, fee services—whether for you or members of your family or household—are just as objectionable as kickbacks. And their consequences are just as serious.

Similarly, in any activity involving our suppliers, you may not do anyone any favors beyond common courtesy. Favors may not be solicited, and if you are offered any unsolicited favors, you must decline them. If you should ever be confronted with this problem, handle it pleasantly and diplomatically—but be firm about it. And inform your supervisor of the incident.

The Company's ethics policy can be condensed to one standard: The actions you take on behalf of the Company when dealing with our suppliers must always be tempered by integrity and fairness. Acting in any other manner is not acting in the Company's best interests. Our best interests are served only when the Company and the supplier derive equal benefit from the relationship.

CONFLICT OF INTEREST

At Hughes there can be no room for a conflict of interest between your personal affairs and Company business.

You may not engage in any business activity or investment that could prevent you from impartially discharging your duties at Hughes. You may not have a major holding in, or compete against.

You may own mutual funds, and you also may own less than one-tenth of one percent of issued and outstanding securities of any corporation whose securities are traded publicly. You may own your own business, as long as it does not interfere with the satisfactory performance of your work at Hughes. If your outside business could lead you into a professional affiliation with a Hughes supplier or competitor, be careful. Avoid even the appearance of a conflict of interest.

If you think your outside activities could possibly lead to a conflict of interest, you are required to disclose that possibility by completing the appropriate Company form. See your supervisor for guidance.

Even if you are not involved in any outside business activities, you may still be confronted with conflict of interest. Suppose you were asked to sit on a Procurement Review Committee and found that your sister's brother-in-law owned ABC Compa-

ny, a major contender for the procurement. Could you be impartial? Maybe. But to be sure, disclose the relationship and let the committee determine whether a conflict exists.

A family or other personal relationship with a supplier also may present a conflict of interest. In such cases, talk to your boss as soon as you become aware of the situation.

BUSINESS WITH FORMER EMPLOYEES

Business dealings with former Hughes employees are almost inevitable. Other firms often employ people who once worked for Hughes. The chances are good that eventually you will be in a situation where you will be dealing with a former Hughes employee.

You may not conduct any Company-related business with a former employee for one year after his or her termination from Hughes if the former employee is now associated with a current or prospective supplier to Hughes.

This restriction applies only to the former employee's personal participation in any business you may be conducting for Hughes. It is not a blanket restriction against doing business with a qualified supplier who has hired a former Hughes employee. "Personal participation" is defined as the former employee's active participation as a contact, or participation in negotiations to sell or promote the sale of products or services.

SAFEGUARDING INFORMATION

In the course of daily activities, employees often are exposed to information about Hughes and other companies which is not generally available to outsiders or even to other employees.

Proprietary, trade and pricing data is nobody's business but our own. Nobody's. This applies to data that we have in our possession from other companies as well as to Hughes data. Discuss information about Company business, Company personnel or firms with which we do business only with those who need to know it.

Never do or say anything that would compromise or misuse Company or supplier information or that would adversely affect the interests or reputation of the Company or our suppliers.

Our suppliers assume that the information they give us will be protected properly. This is a trust we intend to keep. These restrictions apply in addition to the rules for protecting classified information.

When procurement decisions are made, the buyer communicates those decisions to the suppliers involved. That is the buyer's job—no one else's.

Company restrictions against disclosure of information do not mean that we must keep quiet at all times about all things. In the normal course of business, the person you are talking to can rightfully be provided with a general picture of the organization and objectives of the Company. But be discreet.

The saying "Talk is cheap" doesn't apply in our business—talk with the wrong people can be very costly.

SUMMARY

Any policy statement has its limitations. It cannot answer all questions, especially on a subject as broad as ethics.

Ethics and behavior are people issues, and different people may have different perspectives. But in business operations at Hughes, you are expected to know whether what you are doing is right and above board according to the principles discussed in this statement. If there is any doubt in your mind, consult your management.

Hughes Aircraft Company enjoys an outstanding reputation. Our objective is to make sure that it is upheld. We set high standards of performance—for ourselves and our suppliers.

People who do business with us, or who want to do business with us, must respect those standards. They must also respect and be able to rely on our standards of conduct, which are the foundation of our policy of uniformly ethical, fair and considerate treatment of every present and potential supplier.

There is no room for favors or favoritism in the procurement process. No room for personal interests over the Company's interest. No room for indiscretion. There is room only for conducting our business in such a way that our customers get the best product value—which they deserve and expect from Hughes—a product value that reflects the complete integrity of ourselves and our suppliers.

There is only one acceptable way to conduct business at Hughes. It's a matter of integrity.

[From the Wall Street Journal, Nov. 14, 1985]

ON THE TAKE: INVESTIGATORS DETECT PATTERN OR KICKBACKS FOR DEFENSE BUSINESS

THEY FIND THE SUBCONTRACTORS SOMETIMES MUST PAY OFF EMPLOYEES OF CONTRACTOR

(By Edward T. Pound)

CHESTER ADAMSKY'S DOWNFALL

CHULA VISTA, Calif.—There was a time, not too long ago, when Chester Adamsky seemingly had it made.

He was a well-paid executive at Raytheon, Co., a major defense contractor; he lived in a $600,000 home in Santa Barbara, drove a new Cadillac and was co-owner of a posh Palm Springs lingerie shop called Exclusively Intimate.

Nowadays, though, Mr. Adamsky is driving an old Toyota and getting by selling cars at the Ford dealership here. He is also a convicted felon, his house was foreclosed on, and recently he and his shop were declared bankrupt.

The reason for Mr. Adamsky's downfall: He got caught taking kickbacks from companies that own subcontracts on work Raytheon was doing for the Defense Department. All told, Mr. Adamsky admits taking $237,000 during a two-year period. "I needed the money, so I took the money," he explains matter-of-factly. "It ruined me."

GUILTY PLEAS

Subcontractor payoffs to executives and purchasing agents of military contractors are attracting increasing attention from federal investigators. In Los Angeles, 10 former employees of three major aerospace concerns recently pleaded guilty to awarding defense subcontracts in exchange for kickbacks, mostly cash: more indictments are expected. In another case, two former representatives of a Navy contractor conspired to extort $70,000 in kickbacks from a small San Diego-area subcontractor. One of the men, a prosecutor said in court, used the cash for an expensive life style of "fancy hotels, women and champagne."

Investigators say that some subcontractors use whatever blandishments it takes—cash, vacations, liquor—to win over purchasing agents for both defense and commercial contractors.

"I think there has been a lot of it—payoffs from subcontractors—going on. It is a common business practice in the defense industry," says Bruce Kovens, the director of investigative operations for the Pentagon's Defense Criminal Investigative Service. And in Wichita, Kansas, where several aircraft manufacturers are based, the U.S. attorney, Benjamin Burgess Jr., says that his office and the Internal Revenue Service are jointly looking into kickback schemes involving defense and nondefense businesses.

EFFECT ON COSTS

The bribes and abuses, investigators say, add to defense costs and eliminate competition. They note that Emerson Electric Co., a St. Louis based electronics concern, recently paid the Defense Department $325,000 for overcharges stemming from a system of rigged bids and kickbacks received by Emerson employees during the 1970s. A prosecutor describes Emerson, which cooperated with a federal criminal investigation, as a "victim" of corrupt employees and suppliers.

Military contractors say that most employees and subcontractors are honest, and that when contractors detect corruption they usually turn the information over to criminal investigators. But Democratic Rep. John Dingell of Michigan, the chairman of a House investigations subcommittee, plans hearings based on staff information indicating that some contractors fire corrupt employees without telling federal authorities or others in the defense industry.

For instance, subcommittee investigators say, a purchasing agent on the West Coast who was fired by two major aerospace companies for taking kickbacks is now working for a third.

"IT'S THAT EASY"

Henry Rossbacher, a former federal prosecutor in Los Angeles, say it is relatively easy in the multibillion-dollar defense industry to gather a bundle of illicit cash. Mr. Rossbacher prosecuted Mr. Adamsky, the former Raytheon executive, and says: "For the most part, whenever Chet Adamsky asked for money, he got it. It's that easy to get paid."

Before he was caught, Mr. Adamsky, now 52 years old, was a well-respected middle-level manager at Raytheon, an aerospace company based in Lexington, Mass. He worked for a Raytheon division in Santa Barbara and for a while managed a $300 million program that develops radar-jamming equipment for Air Force fighter jets.

But Mr. Adamsky was pressed for money. He was making $3,200-a-month mortgage payments on a house in an exclusive section of Santa Barbara, making hefty lease payments on his Cadillac and straining to keep afloat his lingerie shop, which he says he bankrolled for his girlfriend.

Records filed by prosecutors in federal court in Los Angeles show that Mr. Adamsky alleviated his money crunch by offering Raytheon subcontractors the services of a consulting firm he had set up, A&H Associates. Prosecutors say that Mr. Adamsky didn't do any actual work for the subcontractors, which funneled money to A&H or to Mr. Adamsky personally to get business from Raytheon.

According to a criminal complaint filed against Mr. Adamsky, one Raytheon subcontractor, Feustal Industries Corp. of Plainview, N.Y., paid Mr. Adamsky $150,000 in return for his pledge not to reveal that Feustal was diverting advance payments it had received from Raytheon—spending them on a private venture instead of a defense project. The investigation of Feustal's role is continuing, and no charges have been filed; officials of Feustal couldn't be reached for comment.

Also according to the prosecutors' court filings. Alpha Industries Inc. of Woburn, Mass., paid Mr. Adamsky $57,000 in kickbacks (the firm pleaded guilty to paying one kickback), and Venus Scientific Inc. of Farmingdale, N.Y. paid him $30,000 (Venus cooperated with federal authorities and wasn't charged.)

Mr. Adamsky's scheme fell apart when he solicited a $50,000 kickback from another supplier, Eldec Corp. of Lynwood, Wash., which rejected his overture and reported in to Raytheon. Raytheon conducted its own inquiry, then called in the Federal Bureau of Investigation. Mr. Adamsky was fired in December 1983, and last year he pleaded guilty to the kickback scheme.

GRATEFUL FOR PROBATION

Sitting in his cubbyhole office at Fuller Ford in Chila Vista, the lanky, mustachioed Mr. Adamsky says he is thankful that he got probation but says he probably should have been jailed. "I believe in a strong judicial system," he adds, "Like in Saudi Arabia, when you steal, you get your hand cut off."

Mr. Adamsky had better not offer a machete to Alpha Industries.

The electronics company angrily maintains that it was "conned" by Mr. Adamsky into paying his A&H Associates for a useless marketing study. But a federal grand jury in Los Angeles charged that Alpha paid Mr. Adamsky to get subcontracts on a radar-jamming program, and the company subsequently was suspended from obtaining Pentagon-related business.

George Kariotis, Alpha's chairman, says the scandal "really kind of wrecked this company for a while." He estimates that the suspension cost Alpha, which has annual sales of about $70 million, some $10 million in government-related business. The suspension was lifted last May, after Alpha agreed to plead guilty and to pay the government $97,000 in damages and fines. Ironically, according to papers filed by prosecutors in Los Angeles federal courts, Raytheon had decided to award Alpha the business before Alpha and Mr. Adamsky struck their deal.

INVESTIGATIONS CONTINUE

Investigations are continuing into subcontract or payoffs in the aerospace industry in Southern California where 10 former purchasing agents and executives—eight from Hughes Aircraft Co. and one each from Teledyne Inc. and Northrop Corp.—have pleaded guilty in Los Angeles federal court to criminal charges. A fourth company, Garrett Corp. acknowledges that about six purchasing agents in its AlResearch Manufacturing Co. unit are being investigated by the FBI and the U.S. attorney in Los Angeles, Garrett says it called in federal authorities.

Fred Heather, a federal prosecutor, says that purchasing agents can have a hammerlock on subcontractors and can misuse their positions to deny business to those

who won't pay. Mr. Heather says that when one subcontractor, Richard Haskell of R.H. Manufacturing Co. stopped paying kickbacks to several employees of Hughes Aircraft's Electro-Optical & Data Systems group, they refused to give him any new business. The prosecutor says that Mr. Haskell then told Hughes officials about his involvement in kickback schemes and that they contact the FBI.

Mr. Haskell agreed in January 1984 to cooperate with the FBI and began to secretly tape record his conversations with Hughes employees. Using cash supplied by the bureau, he paid kickbacks to the eight Hughes employees in return for machine parts subcontracts for weapons systems. Along the way he also recorded his conversations with a Northrop manager and paid him cash, too.

A vice president of Teledyne's Camera System unit was caught by the FBI net when he accepted a $2,800 kickback from another supplier who was working with the FBI. The government says that the Teledyne executive deposited his kickback in a company appropriately called Profit Makers Enterprises.

$37,000 PAID IN PERIOD

All told, kickbacks paid to the 10 men during the undercover operation totalled about $37,000. But prosecutor Heather says that those payments were made during a period of only several months and that the kickback schemes had been going on for several years. Furthermore, in a memorandum he filed in federal court, Mr. Heather disclosed that he and the FBI are investigating allegations that a former Hughes supervisor recieved $250,000 in kickbacks in one year.

Mr. Heather says in an interview that the investigation also disclosed that subcontractors involved in kickbacks were generally required to pay 5% on the total subcontract amount. And according to another memorandum the prosecutor filed in federal court, the Northrop manager Mr. Haskell talked to, Ronald Emile Brousseau Sr., hoped to make enough in kickbacks from the Stealth bomber program to retire early.

In a taped conversation, Mr. Brousseau told Mr. Haskell, the government informer, that he wasn't greedy. ". . . A nickel (5% of the subcontract value) here and a nickel there," Mr. Brousseau explained, "Everybody's gonna get fat and everybody's gonna be happy, and at 55 I'm gonna say goodbye, guys: I'm gonna buy my little cabin and my fishing boat on a river."

Like the eight Hughes employees and the Teledyne executive, Mr. Brousseau is one of the Southern California 10 who have pleaded guilty to kickback charges.

PENTAGON CHANGES TACTICS

Expressing the view of most defense contractors, Tom B. Carvey, a Hughes staff vice president, says that the company believes kickback schemes involve only a small minority of suppliers and purchasing agents. But he is frank to say that Hughes remains concerned that "we may have a number of areas where this may (still) be going on" and has been warning employees and subcontractors that it won't tolerate corruption.

Before the current crackdown, the Pentagon didn't check subcontractors very closely. "We rely on our prime contractors to do that job," says Michael Eberhardt, who oversees investigations for the Pentagon's inspector general. But now at the first hint of corruption, he says, the Pentagon intends to focus on the subcontractors as intensely as it does on prime contractors.

Errol Marshall, a small Navy subcontractor, favors closer scrutiny of subcontractors. He once was a part owner of Hydraulic Parts & Components Inc., of Hypac, a San Diego-area company that paid $70,000 in kickbacks to supply heavy equipment for a major construction project at Diego Garcia, an Indian Ocean naval base. Two materials managers of Houston-based Brown & Root Inc., a partner that acted as the project's prime contractor, "demanded the kickbacks," he says. "It was cut and dried. We would not get the business otherwise."

Mr. Marshall, who played a relatively minor role in the scheme, wasn't charged. But one of the Brown & Root managers, M. William Cllan, was convicted last year of extorting kickbacks from Hypac. The other, Frank Di Domenico, pleaded guilty.

Hypac's president, Steven Sandahl, once took out a second mortgage on his home to meet Mr. Callan's demands for cash, say prosecutors' papers filed in federal court in San Diego. Hypac, the papers and court testimony show, also paid for vacations for Messrs. Callan and Di Domenico, and Mr. Sandahl often picked up Mr. Callan's dinner and bar bills at Houston restaurants and a topless-dancer nightclub. Once, Mr. Callan charged a $150 bottle of champagne to Mr. Sandahl's hotel bill. Mr. Sandahl, who testified against Mr. Callan under an immunity grant, declines comment.

James Baxter, a former Hypac supplier, says Mr. Sandahl believed that lavish spending impressed customers: "He'd say, 'You have to look like a big shooter with these big companies.' "

[From the Los Angeles Times, Aug. 9, 1985]

KICKBACKS: NEW GROWTH INDUSTRY

(By Ralph Vartabedian)

John Power, who runs a small Southern California defense factory, has seen the military spending boom create new business opportunities in his industry—but not all are the type that the Pentagon has in mind.

Crooked purchasing agents at major aerospace firms have established their own growth industry, Power said, one based on taking cash kickbacks and expensive gratuities in exchange for awarding Pentagon subcontracts.

"There is a lot of corruption, both at the buyers and management level," he said, "There are a lot of honest buyers. But there are those who ask for money and those who quietly hint they'll not be offended by your offer."

BECOME ENTRENCHED

Such outspoken remarks are unusual for someone in Power's position, but they confirm a growing perception in defense and law enforcement circles that kickbacks have become entrenched in the purchasing end of the defense industry and threaten the integrity of the military procurement system.

"Corrupt schemes in this area are a significant problem," U.S. Atty. Gen. Edwin Meese III said in a statement to the Times. "The problem is one of our principal areas of focus in . . . protecting taxpayers against predatory economic crimes."

Subcontractors have footed $25,000 liquor bills to keep buyers supplied. They have paid for buyers' European vacations and workday golf outings at posh Orange County country clubs. One buyer's home mortgage was paid in exchange for an important contract award, according to industry officials.

In the most dramatic recent action against such illicit payments, 10 purchasing agents and executives at the Southern California defense firms of Hughes Aircraft, Northrop and Teledyne were charged in federal court with taking $100,000 worth of cash kickbacks over a period of several months. Within the last several months, nine of the 10 have pleaded guilty.

FRACTION OF EMPLOYEES

The 10 represent only a fraction of the more than 500,000 employees in California's huge defense industry and only a small number of those involved in purchasing activities. Although many buyers are unswervingly ethical, U.S. Atty. Robert C. Bonner of Los Angeles said that those charged represent only the "tip of the iceberg." The practice of paying outright cash bribes and kickbacks is "widespread" throughout the industry, he said.

Some industry executives believe that the problem needs to be faced head-on. "We fear that it is widespread," said Tom B. Carvey, Hughes vice president for corporate material. "We have had eight employees indicted . . . We are very concerned."

The Department of Defense is investigating alleged bribery schemes at seven other major defense firms, which are among 45 contractors under criminal investigation for various reasons, according to a list recently released by congressional sources. In addition, the FBI has underway an unspecified number of other bribery probes.

Many industry officials said that the recent investigative activity in this area makes the problem appear more pervasive than it actually is. The recent indictments in Southern California and other allegations are exceptions in a business that is honest and committed to the public interest, they say.

"I resent the hell out of the allegation that corruption is widespread in this industry," said H. David Crother, vice president of Lockheed Corp. "I maintain that absolutely is not the case . . . Everybody thinks this industry is fair game for their shots."

Industry officials noted that their own firms, in many cases, are the victims of bribery and kickback schemes. "When a buyer accepts a kickback, it is Lockheed they are hurting," Crother said. "The first and primary damage is to the corporation."

At the same time, corporations have a duty to protect the reputation of honest employees until proof of a crime is in hand, Hughes' Carvey said, noting that disgruntled vendors who lose contracts sometimes make false allegations that a buyer took a bribe.

"This is a very competitive business," he said. "A salesman who has lost a sale may tell his boss, 'Well, we lost that sale because that guy over at Hughes is taking kickbacks from the other guy.' It is very important to us to protect our people from false and spurious accusations."

Hughes has begun a major effort to ensure the integrity of its purchasing activities and was among the first contractors to cooperate closely with law enforcement authorities.

"To some degree, we are glad to get it out in the open. We are anxious to clean up anything that is going on," Carvey said.

"PROSTITUTES THE SYSTEM"

The evidence of corruption now drawing increased attention represents an especially disturbing aspect of the Pentagon's problems, defense officials said. While defense contractors have been widely attacked for high prices, poor quality and unreliable products, many of these problems fall into the category of honest disputes.

"Bribes and kickbacks strike at the very integrity of our purchasing system," said Derek J. Vander Schaaf, deputy inspector general at the Defense Department. "It prostitutes the system and the whole system will break down if we let it go on."

An investigation by the FBI found that suppliers involved in the Southern California schemes had a going rate for bribes. They would generally kickback to the prime contractors' buyers 5% of the face value of subcontracts.

"The fact that a rate exists is disturbing," U.S. Atty. Bonner said. "One of these purchasing agents was able to negotiate a 10% rate. It appears this has a level of refinement, that it is widespread and that it has been going on for some time."

If such practices are indeed widespread, then millions, if not tens of millions, of federal dollars are being skimmed off the top of the annual $100-billion Pentagon procurement budget.

"It breaks my heart to see the Department of Defense make such a big fuss about $5,000 coffee pots when there are guys who are taking a lot more under the table," Power said. Power said he will not pay cash kickbacks.

Corruption appears to be greatest in the awarding of small contracts in the metal-forming industry, such as shops that machine, forge and cast metal parts, according to court records and interviews.

The defense procurement system, with its multibillion-dollar contracts and massive bureaucracy, seems to encourage what one law enforcement official called a "subculture" of graft, which starts with small gifts and gratuities.

A buyer at Rockwell International who finds the practice repulsive, blames much of the problem on moneyed and unscrupulous subcontractors who entice often low-paid administrative workers at big prime contractors. Already cynical because of sloppy procurement practice, such as Pentagon payments of $425 for a hammer and $659 for an ash tray, such administrative staffers turn out to be receptive.

PLEADED GUILTY

"The way it happens is the vendor asks, 'What does it take to get an order?' " the Rockewll buyer said. "At that point, you know they are making an offer for a kickback."

In the Los Angeles case brought by Bonner's office, Philip R. Kaiser, a 48-year-old purchasing supervisor at Hughes Electro Optical Data Systems Group in El Segundo, was indicted by a federal grand jury on charges of taking $5,400 in cash kickbacks from Richard Haskell, a part owner of R.H. Manufacturing in Chatsworth.

Kaiser has since pleaded guilty to federal charges that he accepted cash bribes and a European vacation, including air fair, hotel rooms and a rental car, from Haskell. Moreover, several buyers working under Kaiser also have pleaded guilty to involvement in the scheme.

Although Bonner declined to discuss specifics of the Hughes cases, several defense subcontractors said that they were aware that some Hughes buyers were taking payoffs, sometimes in the lobby of a company facility and at two El Segundo restaurants, the Hacienda and the Golden Tail.

In some of the cash hand-offs, knowledgeable sources said, a vendor would go to the Hughes lobby and hand over to a Hughes buyer an issue of Aviation Week and Space Technology, a well know aerospace trade magazine, with money slipped in between the pages.

Even more brazen was the scheme allegedly set up by Teledyne's Richard Floyd Herbert, 52, who was vice president and general of Teledyne's Camera Systems unit in Arcadia.

Herbert pleaded guilty to charges that he accepted kickbacks in exchange for awarding contracts to an Orange County machine shop and that he laundered the money through a company he set up for that purpose. The company was called Profit Makers Enterprises.

"This wasn't a case where somebody had a moment of weakness and took a $100 bill." A source close to the case said—this was an elaborate scheme with clear-cut criminal intent."

A Teledyne spokesman said the company was not aware of the investigation into Herbert's activities until after he resigned from the company earlier this year.

Even when outright cash kickbacks are not involved in a government subcontract, the system operates on a steady flow of gratuities—including gifts, free entertainment and expensive meals, said the buyer at Rockwell International, who has been in a position to observe such practices through his work at several defense firms.

FREE GOLF, TICKETS

The personal preferences of buyers at the prime defense contractors—their favorite restaurants and liquor brands—become a daily headache, according to a subcontractor who asked not to be named.

During the Christmas season, for example, many defense suppliers become veritable Santa Clauses. One defense subcontractor in Los Angeles, who asked not to be identified, said that each yule season he doles out $25,000 worth of liquor to customers—a practice that is almost universal in the weapons business, he said.

The entire purchasing department of one large Orange County subcontractor spends every Friday afternoon on a country club golf course, according to one supplier who did business with the firm. The golf outings are paid for by vendors. Tickets to major sporting events also are a popular way to reward purchasing agents.

"A meal or a bottle of liquor becomes the common ground that opens a relationship for larger offers that can be made informally," said Fred Heather, an assistant U.S. attorney in Los Angeles. 'The inexpensive lunch may lead to dinner at the country club, maybe after a round of golf. Eventually, it grows to a weekend in Las Vegas. These things have a way of elevating. Relationships build up. In order to keep up appearances of fairness, the safest route is saying no to everything."

Such a puritanical approach puts a heavier onus on the defense industry than on most other businesses, where a free lunch is viewed as an acceptable and useful way to build business ties. But some law enforcement officials contend that the defense industry must live up to a higher standard.

"When you are doing business with the government, there is a public trust involved," Bonner said. "In that sense, the public has a right to expect a higher level of conduct from the defense industry."

In at least some cases, criminal activity appears to persist because corporate management prefers to deal with corruption quietly.

When management at a large prime contractor becomes aware that a purchasing agent is taking bribes, the agent is usually fired—"walked out" in industry parlance. Often enough, the buyer ends up with a job at another defense firm and sets up a new graft scheme, Bonner said.

"Management, with very little vigilance, could determine whether kickbacks are being paid," Bonner said. "If there is acquiescence of kickbacks . . . there could be criminal responsibility on the part of not only the officers of a corporation but of the company itself."

MORTGAGE PAYMENTS

But corporations say that they seldom have the hard evidence to prove that an employee has taken a bribe. Often, a corrupt employee quickly leaves a job once he is suspected of wrongdoing, ensuring that his employment record will be clean.

A story widely circulated in the defense subcontracting industry involves one buyer who was known to be taking bribes while working for a major prime contractor in Los Angeles. He was fired from the job, but quickly set himself up in a new graft scheme at TRW Inc. in Redondo Beach.

While at TRW, he received monthly mortgage payments on his home in exchange for awarding a lucrative subcontract to the owner of a San Gabriel Valley firm.

According to an informed source, when the subcontractor fell behind schedule on the contract and was threatened with cancellation by other TRW officials, he re-

portedly protested that he was paying the buyer's mortgage to assure him of TRW's business.

Today, the buyer works at another defense electronics company in surburban Los Angeles. A TRW spokeswoman said she could not discuss the incident, but added that as a general policy TRW turns over any evidence of crimes committed by its employees to appropriate law enforcement agencies.

The size of the defense business complicates the task of weeding out corruption. Hughes, for example, does about $2.2 billion in business with as many as 7,000 subcontractors, according to Carvey, the vice president, with about 80% of all that buying done at the division level. Policing such far-flung operations is not easy.

Carvey observed that many aerospace products are technically sophisticated and unique. It may be impossible to say what a product should cost if it has never been made before. In addition, manufacturers' bids on products frequently vary widely and can easily conceal a small margin for a kickback.

NOT A NEW PROBLEM

While recent cases have drawn more attention to the problem of kickbacks in the defense industry, evidence of such a problem in the defense industry dates back years.

In 1974, nine Grumman employees pleaded guilty to accepting $500,000 in kickbacks on Navy work. Federal officials said at the time that they had found "indications of similar payoff schemes elsewhere in the defense industry."

General Dynamics is currently the target of half a dozen federal investigations, many growing out of allegations that bribes were taken from the now-defunct Frigitemp Corp. in connection with the award of subcontracts for work on nuclear submarines. The General Dynamics executive who made the allegations, P. Takis Veliotis, is now a fugitive in Greece from a federal indictment alleging that he also took kickbacks.

Similarly, the FBI is currently investigating whether former Lockheed and Litton Industries employees may have taken bribes from Frigitemp in awarding contracts at their shipyards.